NFA NATIONAL FUTURES ASSOCIATION
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January 25, 1990

Ms. Jean A. Webb
Secretariat
Commodity Futures Trading Commission
2033 K Street, N.W.
Washington, D.C. 20581

Re: National Futures Association: Proposed Amendments to NFA Compliance Rules 2-12 and 2-33; and NFA Financial Requirements Sections 1, 6, and Schedule D, Section D3-d

Dear Ms. Webb:

Pursuant to Section 17(j) of the Commodity Exchange Act, as amended, (the "Act"), National Futures Association ("NFA") hereby submits to the Commodity Futures Trading Commission ("Commission") proposed amendments to NFA Compliance Rules 2-12 and 2-33 and to NFA Financial Requirements Sections 1, 6, and Schedule D, Section D3-d (collectively referred to as "Proposed Rules"). The Proposed Rules were approved by NFA's Board of Directors ("the Board") at its meeting on December 7, 1989. NFA respectfully requests Commission review and approval of the Proposed Rules.

The Proposed Rules strengthen the financial and reporting requirements for Futures Commission Merchants ("FCMs"). The Board has determined that these amendments are necessary in order to provide greater customer protection from FCM insolvencies. Furthermore, the Board believes that the Proposed Rules are the least anticompetitive means of achieving this goal.

## I. INTRODUCTION AND BACKGROUND

Late last year X-Cel Commodities Corporation ("X-Cel"), an NFA Member FCM which was not a member of any exchange, became undercapitalized and undersegregated as a result of a default by a handful of customers who had suffered large market losses. The firm's own capital was not sufficient to cover the default, and the firm ultimately became insolvent. The FCM carrying the customer omnibus account liquidated the open positions in the omnibus account, and approximately $100,000 in non-defaulting customer funds appears to have been lost.

In reconstructing the events leading to the insolvency of X-Cel, NFA noted that X-Cel was thinly capitalized. It also

appeared that the FCM carrying X-Cel's omnibus account may have had information which, if relayed to NFA, could have identified the firm's emerging financial difficulties before they escalated. This information included the acceptance of uncertified checks which were subsequently returned to the clearing FCM due to insufficient funds.

The X-Cel insolvency was similar to a number of other FCM insolvencies over the years which involved a loss of customer funds. NFA's Customer Account Protection Study[1] indicates that almost all of the FCMs that failed between 1938 and 1985 were thinly capitalized, closely held firms with few principals. The majority of these failures involved some sort of malfeasance by insiders of non-exchange member FCMs. More recently, since NFA assumed regulatory responsibilities for FCMs, most of the failures have been caused by deficits in customer accounts arising from the inability of the firm to collect margins from those customers. In these later cases, the FCM's capital was insufficient to cover the resulting short-fall in segregated funds.

The apparent loss of customer funds from the X-Cel failure prompted NFA's FCM Advisory Committee ("FCM Committee") to study possible changes to NFA Financial Requirements and Compliance Rules to provide further protection against FCM insolvencies. In developing the Proposed Rules, the FCM Committee determined that these changes were necessary for the protection of customer funds from insolvency losses. The FCM Committee also determined that the Proposed Rules are the least anticompetitive means available to NFA for the protection of these funds.

On August 31, 1989, the FCM Committee issued a Notice to FCM and IB Members (#I-89-19) seeking comments on the Proposed Rules. These comments were considered by the Board of Directors when adopting the Proposed Rules. The Board of Directors was also advised of the failure of Interbrokers USA, Inc. ("Interbrokers") which had occurred since the FCM Committee proposed its changes to the Financial Requirements and Compliance Rules. This failure further emphasized the need for the Proposed Rules.

In most respects, the Interbrokers failure fits the same factual pattern as X-Cel and other recent failures. The insolvency resulted from losses in large spread positions in segregated accounts. When the resulting margin calls were not

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1 NFA Customer Account Protection Study (1986) at 15-37.

met, all of the positions in the customer omnibus account were liquidated. As with other recent failures, Interbrokers was a thinly capitalized firm, and its capital was not sufficient to cover the shortage in segregated funds resulting from the large deficits in the accounts of a few customers.

The Board of Directors has adopted the Proposed Rules as the least anticompetitive means of providing customers with necessary protection from FCM insolvency losses. The Proposed Rules:

1. increase the FCM minimum adjusted net capital requirement from $50,000 to $250,000;

2. clarify the financial reporting requirements of Member FCMs;

3. require that Member FCMs for which NFA is the designated self-regulatory organization ("DSRO") notify NFA if they have any reportable positions;

4. require that each FCM doing business on an omnibus account basis provide NFA with a complete listing of all FCMs carrying its omnibus accounts; and

5. require that a clearing FCM carrying customer omnibus accounts promptly notify its DSRO or NFA if the FCM accepts any form of funds other than immediately available funds from an omnibus account.

II. TEXT OF THE AMENDMENTS

Following is the text of the proposed amendments to NFA Compliance Rules 2-12 and 2-33 and to NFA Financial Requirements Sections 1, 6 and Schedule D, Section D3-d. Additions are underscored and deletions are {bracketed}.

**COMPLIANCE RULES**

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**Part 2 -- RULES GOVERNING THE BUSINESS CONDUCT OF MEMBERS REGISTERED WITH THE COMMISSION**

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**Rule 2-12. OMNIBUS ACCOUNTS.**

(a) A Member FCM, whether or not a contract market member, carrying omnibus accounts of any kind in commodity futures must maintain with NFA a complete list of all such omnibus accounts, and shall immediately notify NFA when new omnibus accounts are opened and when existing accounts are subsequently closed. Information for each omnibus account must include account name and address, and an indication of the type of account as either house or customer and regulated or unregulated.

(b) Each FCM doing business on an omnibus basis must maintain with NFA a complete list of all FCMs carrying its omnibus accounts, including the addresses of such FCMs, and shall immediately notify NFA of any changes in such information.

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**Rule 2-33. FCM RECEIPT OF FUNDS FROM OMNIBUS ACCOUNTS.**

Each FCM must give notice to its DSRO or, if so directed by its DSRO, to NFA whenever the FCM accepts other than immediately available funds from an FCM doing business on an omnibus basis. Notice must be received within 24 hours of such acceptance. For purposes of this Rule, wire transfers and certified checks shall be considered immediately available funds for which notice is not required.

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**FINANCIAL REQUIREMENTS**

**Section 1. Minimum Financial Requirement.**

Each NFA Member that is registered or required to be registered with the Commodity Futures Trading Commission (hereinafter "CFTC") as a Futures Commission Merchant (hereinafter "Member FCM") must maintain "Adjusted Net Capital" (as defined in Schedule A hereto) equal to or in excess of --

(a) The greatest of --

(i) $250,000, or

(ii) 4 percent of the funds required to be segregated pursuant to the Commodity Exchange Act and CFTC Regulations and the foreign futures or foreign

options secured amount, less the market value of commodity options purchased by customers on or subject to the rules of a contract market or a foreign board of trade, provided, however, the deduction for each customer shall be limited to the amount of customer funds in such customer's account and foreign futures and foreign options secured amounts; or,

(iii) (for securities brokers and dealers), the amount of net capital specified in Rule 15c3-1(a) of the Regulations of the Securities and Exchange Commission (17 CFR 240.15c3-1(a)).

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**Section 6. REPORTING.**

(a) A Member FCM that knows or should have known that its Adjusted Net Capital is less than the amount required by Section 1 must give telegraphic notice to its DSRO within 24 hours.

(b) A Member FCM must file a written notice with its DSRO, within 5 business days, when the FCM knows or should have known that its Adjusted Net Capital is less than the greatest of (i) $375,000, or (ii) 6% of the funds required to be segregated pursuant to the Commodity Exchange Act and CFTC Regulations and the foreign futures or foreign options secured amount, less the market value of commodity options purchased by customers on or subject to the rules of a contract market or a foreign board of trade, provided, however, the deduction for each customer shall be limited to the amount of customer funds in such customer's account and foreign futures and options secured amounts, or (iii) for securities brokers or dealers, the amount of capital specified in Rule 17a-11(b) of the Regulations of the Securities and Exchange Commission (17 CFR 240.17a-11(b)).

(c) Whenever a Member FCM is required to give notice to the CFTC pursuant to CFTC Regulation 1.12, the FCM also is required to give such notice to its DSRO.

[Any FCM Member who violates CFTC Regulation 1.12 shall be deemed to have violated an NFA Requirement. Each FCM Member for which NFA is the DSRO and which is

required to file any document with or give notice to the CFTC under CFTC Regulation 1.12, shall also file one copy of such document with or give such notice to NFA at its Chicago office no later than the date such document or notice is due to be filed with or given to the CFTC. Each Member must also file the reports specified in Schedule D hereto with its DSRO.]

[[Note: Under CFTC Regulation 1.12(a), a Member FCM that knows or should have known that its Adjusted Net Capital is less than the amount required by Section 1 must give telegraphic notice to its DSRO and the CFTC (and the SEC if the FCM is also a securities broker or dealer) within 24 hours. Within 24 hours after giving that notice, certain financial reports (see CFTC Regulation 1.12(a)(2)) must similarly be filed. In addition, under CFTC Regulation 1.12(b), a Member FCM must similarly file a written notice, within 5 business days, when the FCM knows or should have known that its Adjusted Net Capital is at any time less than $75,000 or 6% of the funds required to be segregated under Section 4d of the Commodity Exchange Act and CFTC regulations, less the market value of commodity options purchased by option customers on or subject to the rules of a contract market, provided, however, the deduction for each option customer shall be limited to the amount of customer funds in such option customer's account; or, (for securities brokers or dealers) the amount of capital specified in Rule 17a-11(b) of the Regulations of the Securities and Exchange Commission (17 CFR 240.17a-11(b)). CFTC Regulation 1.12(b) imposes other requirements on FCMs, as do other provisions of Regulation 1.12 and of Regulations 1.10, 1.16 and 1.18. The full text of Regulations 1.10, 1.12, 1.16 and 1.18 should be consulted.]]

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**SCHEDULE D**

**FINANCIAL REPORTS**

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**Sec. D3-d. NOTIFICATION OF REPORTABLE POSITIONS.**

Each Member FCM for which NFA is the DSRO and which is required to file any document with or give notice to the CFTC

under CFTC Regulation 15.03 shall also file one copy of such document with or give such notice to NFA at its Chicago office no later than the date such document or notice is due to be filed with or given to the CFTC.

## III. EXPLANATION OF PROPOSED RULES

1. Financial Requirements Section 1. NFA's minimum net capital requirement for FCMs has been raised from $50,000 to $250,000. NFA believes that changes in the industry over the past decade require a corresponding change to the minimum net capital requirement. As noted above, thinly capitalized FCMs have historically posed the greatest risk of insolvency. A change in the minimum net capital requirement is necessary in order to provide the same degree of customer protection that was provided by the $50,000 requirement when it was originally adopted in 1978. NFA believes that the minimum net capital requirement must be raised to at least $250,000 in order to regain the protection that was provided by the adoption of the $50,000 capital requirement in 1978.

The Board has determined that the proposed increase in the minimum net capital requirement is necessary in order to provide a greater measure of protection from FCM insolvencies. In addition, as discussed further in the following section, NFA believes that the proposed increase is the least anticompetitive means of achieving this goal.

2. Financial Requirements Section 6. Generally, this section has been revised to clarify the financial reporting requirements of Member FCMs. Also, the early warning level has been changed to $375,000 (150% of the proposed new requirement) rather than $75,000 (150% of the CFTC's current minimum net capital requirement).

These changes are intended to increase the likelihood that NFA or the relevant DSRO will receive timely notice of events which increase the risk of insolvency and provide a possible threat to the safety of customer funds. Timely notice of these events increases the likelihood that the relevant DSRO will be able to intervene to protect customer funds before they are impaired.

3. Financial Requirements Schedule D, Section D3-d. This is a new section which codifies a current practice requiring FCMs for which NFA is the DSRO to file reportable position

reports with NFA. Such reports are currently requested under Section D3-a of Schedule D.

4. Compliance Rule 2-12. NFA Compliance Rule 2-12 currently provides that all Member FCMs carrying omnibus accounts must maintain with NFA a complete list of omnibus accounts carried by the FCM and must provide NFA with immediate notice of all changes to the list. The proposed change would require FCMs who do business on an omnibus account basis to maintain with NFA a complete list of all firms carrying its omnibus accounts and to provide NFA with immediate notice of any changes to the list. In other words, under the amended rule, both FCMs would be required to report the relationship.

Information on omnibus account relationships is critical in order to insure that NFA can respond quickly when an FCM experiences financial difficulties. Carrying firms sometimes fail to send NFA the information required by Compliance Rule 2-12, and this failure may not be discovered until an audit is conducted. If an FCM doing business on an omnibus account basis runs into financial problems, NFA needs immediate knowledge of the firms carrying the omnibus accounts. Valuable time is wasted if NFA has not been provided with current information on these relationships.

The proposed changes to Compliance Rule 2-12 would place a duty to report the omnibus account on both parties to the relationship. This dual requirement should increase the likelihood that NFA will have current information on file.

5. Compliance Rule 2-33. This proposed rule requires any FCM carrying omnibus accounts to notify its DSRO (or NFA) within 24 hours whenever the FCM accepts omnibus account funds that are not immediately available (e.g., uncertified checks). The use of anything other than immediately available funds by FCMs doing business on an omnibus account basis may indicate that the FCM is experiencing financial difficulties. By promptly notifying its DSRO or NFA of the FCM's actions, the clearing firm provides NFA with information which allows NFA to determine whether further investigation into the solvency of the FCM is warranted.

## IV. SUMMARY OF COMMENTS RECEIVED

NFA received a total of twenty-three comments on the Proposed Rules. Sixteen of the comments were submitted by FCMs,[2]

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[2] These firms include: (1) BNY Futures, Inc., (2) Bachus & Stratton Commodities, Inc., (3) B.W. Dyer and Company, (4) Empire Brokerage Services, Inc., (5) Frontier Futures, Inc.,

nine of which currently have $250,000 or more in minimum net capital and seven of which currently have less than $250,000 in minimum net capital. In addition, one comment was submitted by the Futures Industry Association ("FIA"); one comment was submitted by a certified public accountant;[3] one comment was submitted by an attorney[4] who represents three unnamed FCMs that may be affected by the Proposed Rules; two comments were submitted by attorneys in private practice;[5] one comment was submitted by NFA's IB Advisory Committee ("IB Committee")" and one comment was submitted by an independent introducing broker.[6]

Generally, the comments support NFA's efforts to provide additional customer protection against FCM insolvencies through changes to the Financial Requirements. Most of the comment letters supported an increase in the minimum net capital requirements although some commented that $250,000 is too high. A few of the comments expressed reservations regarding certain of the other Proposed Rules, but these comments were mostly technical in nature and, although they were considered by the Board, they will not be discussed here.

NFA received a total of twenty-two comments regarding the proposed changes to Section 1 of the Financial Requirements. Three of the comments received on behalf of FCMs, one of the comments received from an attorney in private practice, and the comment submitted on behalf of FIA all strongly support the FCM Committee's view that the current FCM minimum adjusted net capital requirement is too low and should be raised to at least

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(6) Futures North, Inc., (7) Geisel Grain Co., (8) Iowa Grain Company, (9) JB Investments, Inc., (10) Klein & Co. Futures, Inc., (11) Mocatta Futures Corporation, (12) Northwest Futures Management, Inc., (13) SGD Commodities Corporation, (14) Shearson Lehman Hutton, (15) Sinclair and Company, and (16) WFC Options Corporation.

[3] Mr. John L. Manley of Touche Ross & Co.

[4] Ms. Debbie Pines, Esq.

[5] Mr. Edward R. Schroeder, Esq. of Lord Day & Lord, Barrett Smith and Mr. Theodore George Lindsay, Esq.

[6] CTA Services Ltd.

$250,000 in order to ensure the financial integrity of FCMs. In particular, one of the comments noted that the present minimum was established in 1978 and that, however adequate it may have been at the time, it is grossly inadequate today. Another one of the comments suggested that once the minimum net capital requirements has been raised, it should be reviewed periodically.

In addition to the above comments, Mr. John L. Manley sent NFA a copy of a letter to the Honorable Wendy Gramm dated March 13, 1989. The letter was written by Mr. Manley and Mr. Edmund R. Schroeder, Esq. in their capacities as receivers for two FCMs which became insolvent within the last several years. In their letter, Messrs. Manley and Schroeder urged the Commission to re-examine the minimum level of capital required for FCMS. They also observed that the current minimum requirement of $50,000 or 4 percent of funds in segregation means that an FCM may carry $1,250,000 of customer margins with a minimum net capital of only $50,000.

In comparison, seven comments (one of which was submitted on behalf of an FCM which currently has less than $250,000 in net capital) stated that the proposed change to Section 1 will be perceived as anticompetitive and/or discriminatory since it could force smaller FCMs out of business and thus would appear to serve the narrow interests of the exchange member FCMs which compete with smaller FCMs. Four comments (two of which were submitted on behalf of firms which currently have less than $250,000 in net capital) espoused the view that "bigger is not always better" and asserted that a greater risk to the industry lies with the potential default of a medium to large sized FCM, which default could dwarf all of the potential loss associated with those FCMs whose current adjusted net capital is below $250,000.

However, four of the twenty-two comments received on this issue (one of which was submitted on behalf of a firm which currently has less than $250,000 in net capital) explicitly stated that the current net capital requirement is too low and proposed alternative methods of raising this requirement. Additionally, eleven of the twenty-two comments received on this issue (six of which were submitted on behalf of FCMs which currently have less than $250,000 in net capital) tacitly acknowledged that the current minimum net capital requirement is too low by proposing alternative methods of raising this requirement. These alternative methods provided by the comment letters are summarized below.

(A) Two comments filed by related firms (one of which currently has less than $250,000 in net capital) agree that changes to the FCM minimum net capital requirement are necessary and advocate raising the requirement for new firms to either $150,000 or $200,000. The comments suggest raising the requirement for existing FCMs by $50,000 a year until their capital reaches the level set for new FCMs or alternatively, giving existing FCMs two years within which to meet the new requirement. These suggestions would supposedly allow the existing FCMs enough time to secure the necessary capital. In comparison, another comment submitted by an FCM which would be affected by an increase in the minimum net capital requirements agreed that the proposed increase is appropriate, but if implemented, existing FCMs should be "grandfathered" and allowed to maintain a minimum net capital of $50,000. Further, one comment stated that firms which are inactive and do not engage in any customer business should continue to be subject to either the current $50,000 minimum or some amount less than $250,000.

(B) A comment filed by the IB Committee recommended raising the minimum net capital requirement from $50,000 to $100,000. The IB Committee also discussed changing the language in Section 1(a)(i) of the Financial Requirements from "or" to "and" in order to add the 4 percent of segregated funds referred to in Section 1(a)(ii) to the dollar amount set forth in Section 1(a)(i); however, the comment stated that the IB Committee was not able to reach a consensus regarding this second proposal. Another comment also proposed raising the minimum net capital requirement from $50,000 to $100,000.

(C) Two comments submitted by FCMs which would be affected by the proposed increase expressed the belief that the only fair way to determine adequate capital requirements is to relate such requirements to segregated funds. One of these comments recommended that Section 1 of the Financial Requirements be revised to require that FCMs maintain a minimum adjusted net capital of $100,000 or 10 percent of segregated funds on deposit. Further, this comment advocated that the Financial Requirements be revised to require an FCM to maintain minimum adjusted net capital of $3,000,000 to guarantee an IB. The second comment suggested that raising the

percentage of capital required from 4 percent to 8 percent of customer segregated funds is a far better way to protect the public. This comment advised that if NFA is concerned with protecting the public and the industry image, industry-wide insurance should be utilized.

(D) Two comments received on behalf of FCMs (one of which would be affected by the proposed increase) and one comment received from an attorney on behalf of three FCM clients (all of which may be affected by the proposed increase) noted that although the Proposed Rules are designed to protect against omnibus insolvencies, Section 1 of the Financial Requirements fails to distinguish between FCMs which clear their customer transactions on an omnibus basis and those which clear their customer transactions on a fully disclosed basis. These comments suggested that FCMs which clear through other FCMs on a fully disclosed basis and/or hold no customer funds in segregated accounts should not be penalized with increased financial requirements. Another comment (filed on behalf of an FCM which currently has less than $250,000 in net capital) proposed that no financial changes be made with respect to FCMs that neither carry customer accounts nor guarantee IBs.

(E) One comment stated that any proposed changes to NFA's Financial Requirements should be consistent and, in that regard, minimum financial requirements also should be instituted for customers and IBs. Specifically, the comment proposed that both IBs and customers should have minimum balances and appropriate capital resources and that no IBs should be guaranteed.

(F) One comment filed on behalf of an FCM which would be affected by the proposed increase stated that Section 1 should be revised to require minimum capital of $50,000 plus $25,000 per guaranteed IB of the FCM.

(G) A comment received on behalf of an independent introducing broker suggested that the FCM minimum net capital requirement should be increased based on the number of each FCM's branch offices or brokers, or by increasing the minimum margin level that an FCM must require from a client.

(H) One comment urged that a less anticompetitive alternative be considered, stating that the barrier to entry caused by the proposed increase may not be reasonably related to the magnitude of the bankruptcy risk. Specifically, the comment suggested that the FCMs which would be affected by the proposed increase should collectively put up a $500,000 insurance fund. The comment opined that such an amount would be well in excess of historical customer losses and would cost each of fifty FCMs an average of $10,000, payable on a one-time only basis.

From the comments received it seems fair to conclude that the FCM community generally supports the efforts of the FCM Committee to provide further protection against FCM insolvencies through changes to the Financial Requirements. A majority of the commentators supported an increase in the minimum net capital requirement although they did not all agree with the FCM Committee's recommendation.[7]

## V. DISCUSSION

The current minimum adjusted net capital level of $50,000 was adopted by the Commission on September 1, 1978, effective December 20, 1978.[8] This was a 500% increase over the previous $10,000 minimum. In addition, a separate minimum net capital requirement was created for non-exchange member FCMs, raising their requirement from $10,000 to $100,000. Although all FCMs were required to have $50,000 in adjusted net capital by December 20, 1978, non-exchange member FCMs were given until June 30, 1979 to raise the additional $50,000.

The required level of minimum adjusted net capital for FCMs has remained at $50,000 for over a decade. The industry,

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[7] It should be noted that with regard to the proposed change to Section 1 of NFA's Financial Requirements, only seven out of a total of fifty-five FCMs which currently would be affected by an increase in the net capital requirement chose to comment on the proposed change. Also, as noted earlier, one of those seven FCMs explicitly acknowledged that the current minimum net capital requirement is too low and the remaining six of those seven FCMs tacitly acknowledged that the current requirement is too low by proposing a number of alternative methods of raising the requirement.

[8] 43 Fed. Reg. 39956 (1978).

however, has changed substantially in that time. Volume on domestic futures markets has increased from 58.5 million futures contracts in 1978 to 245.9 million futures contracts and 49.1 million options contracts in 1988 -- approximately a 500% increase.[9] While volume has grown by 500%, the number of registered FCMs has grown by only 13%, from 325 FCMs in August, 1979[10] to 366 FCMs in December, 1989.[11] This increase indicates that the volume of business done by each FCM has increased significantly in the past decade. In fact, the average amount of funds in segregation at each FCM rose from $8.7 million in 1980 to $28.5 million in 1985 -- a three-fold increase in those five years alone.[12]

In contrast to the growth in the industry, the worth of the dollar, as measured by the Consumer Price Index ("CPI"), has fallen by 46% since 1978.[13] Even if the futures industry had remained static since 1978, the minimum capital requirement would have to be raised to $93,000 just to compensate for the change in the value of the dollar.[14]

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[9] Monthly Volume Report, Futures Industry Association (December 1988); Volume of Futures Trading, Futures Industry Association, reprinted in Commodity Account Protection, a Study by the Division of Trading and Markets, Chart II (1985).

[10] In the Matter of the Application of the National Futures Association, Order Granting Registration and Approving Rules, at 21 (CFTC, 1981).

[11] National Futures Association Monthly Report to the Commodity Futures Trading Commission (December 1989).

[12] Customer Account Protection Study, <u>supra</u> at 37.

[13] The CPI has changed from 67.7 index points in December, 1978 to 125.9 index points in November, 1989. Consumer Price Index, All Urban Consumers (CPI-U) U.S. City Average, All Items 1982-84=100. United States Department of Labor, Bureau of Labor Statistics.

[14] The Commission has stated that two additional reasons for a minimum net capital requirement are:

> (1) {To require} sufficient capitalization so that {a firm} will be encouraged to employ the appropriate personnel, resources and equipment to safeguard its stake in the business; (2) {to insure} that such

In order to provide adequate protection against losses from FCM insolvencies, the capital requirements must keep pace with the growth in the industry, the increase in segregated funds, and the decreasing value of the dollar.[15] Based on the combined effect of these factors, NFA believes that the minimum net capital requirement must be raised to at least $250,000 in order to provide the same degree of protection in the 1990s that was provided by the $50,000 requirement in the 1980s.[16]

The proposed increase to $250,000 is further supported by the history of customer losses due to FCM insolvencies since NFA began operation. In three of the four insolvencies which involved the actual or currently projected loss of customer funds, the insolvency resulted from large customer debits in a handful of accounts.[17] In all four cases the firms maintained

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> registrants have a sense of commitment and obligation to their business sufficient to produce responsible, reliable operations.... 48 Fed. Reg. 14933, 14942 (1983).

Given the change in the value of the dollar, the owners of a thinly capitalized FCM have less of a stake in the FCM and, therefore, less of a commitment to the business than they would have had in 1978.

[15] Section 17(b)(4) of the Act authorizes, and in fact requires, NFA to set standards governing the financial responsibility of its members. Section 17(b)(7) of the Act requires NFA to adopt rules designed to protect the public interest. In addition, Commission Regulations 1.52 and 170.1 require NFA to adopt minimum financial requirements for FCMs; Commission Regulation 170.5 requires NFA to establish and maintain a program for the protection of customers, including the adoption of rules to protect customer funds; and Commission Regulation 170.2 authorizes NFA, when necessary or appropriate in the public interest and to carry out the purposes of Section 17 of the Act, to limit membership to firms having a particular level of capital assets. The Proposed Rules are necessary to NFA's fulfillment of these responsibilities.

[16] This change is not intended to preempt the Commission's ongoing review of the structure of the capital requirement.

[17] The majority of pre-NFA failures involved some sort of malfeasance by insiders of non-exchange member FCMs. Customer Account Protection Study, <u>supra</u> at 15-37.

capital at or only slightly above the current early warning level of $75,000. In three cases the actual or projected losses were between $100,000 and $300,000. Minimum net capital of $250,000 would have covered all of the losses in two of these cases and most of the losses in the third.[18]

Several of the letters commenting on the Proposed Rules stated that the Proposed Rules are anticompetitive because they may put some FCMs out of business. NFA does not dispute that firms which do not have the resources to increase their net capital to $250,000 will have to stop holding customer funds and change their registration category. This is, in fact, the very purpose of the change to Section 1 of NFA's Financial Requirements. If an FCM does not have the resources to increase its adjusted net capital to $250,000, it is not likely to have adequate resources to cover large debits and deficits in its customer accounts and to protect customer funds from being depleted. Forcing thinly capitalized firms out of the FCM business will decrease the risk of customer losses from FCM insolvencies and will increase customer protection.

NFA realizes that the Proposed Rules will place a burden on competition. For that matter, every regulation the Commission or NFA has imposed creates a burden on competition. However, the question is not whether the Proposed Rules will impose a burden on competition, but whether they will impose an unnecessary burden on competition.

Section 15 of the Act[19] requires the Commission, in approving NFA's rules, to take into consideration the public interest to be protected by the antitrust laws and endeavor to take the least anticompetitive means of achieving the objectives of the Act.[20] It does not require or even authorize the Commis-

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[18] In the fourth insolvency, customer losses of $1,500,000 are projected. Although the minimum net capital requirement should be high enough to minimize customer insolvency losses, it cannot provide insurance against such losses.

[19] 7 U.S.C. § 19 (1974).

[20] Section 15 was a partial codification of the "rule of reason" adopted by the U.S. Supreme Court in Silver v. New York Stock Exchange, 373 U.S. 341, rehearing denied, 375 U.S. 870 (1963). Silver was a private antitrust suit against the New York Stock Exchange ("NYSE") for activities which the court found were not subject to direct oversight by the Securities and Exchange

sion to refuse to approve SRO rules merely because they have an anticompetitive effect. In fact, the Commission does not even need absolute assurances that the least anticompetitive means are

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Commission ("SEC"). The Court found against the NYSE, holding that, in the absence of direct oversight by the SEC (or a specific statutory exemption), antitrust immunity applied only if the NYSE's actions were the minimum necessary to fulfill its statutorily imposed self-regulatory duties.

After the enactment of the 1974 amendments to the Act, the U.S. Supreme Court decided Gordon v. New York Stock Exchange, 422 U.S. 659 (1975). Gordon involved an antitrust attack on NYSE fixed minimum commission rates. Unlike the activities involved in Silver, however, § 19(b) of the Securities Exchange Act specifically authorized the SEC to approve or disapprove commission rates, and the SEC had actively exercised that power. Gordon held that three factors led to the inevitable conclusion that § 19(b) impliedly repealed the antitrust laws in regard to Commission rates. The three factors were (1) the statutory provision authorizing regulation, (2) the long regulatory practice (and active oversight by the SEC), and (3) continued congressional approval.

Neither Silver nor Gordon speaks directly to the standards a federal agency should apply in approving the rules of a self-regulatory organization. Silver involved activities not directly subject to the oversight of the SEC, and Gordon dealt with activities that had been sanctioned by the SEC (although the SEC had decided to phase out Commission rates over time). However, both Silver and Gordon provide valuable insight into the appropriate test to be used by the Commission in considering the anticompetitive effects of the Proposed Rules.

The Proposed Rules would easily meet the Gordon test. Like the fixed commission rates in Gordon, the minimum net capital requirement is authorized by federal statute; has long been a regulatory practice in the futures industry which has been sanctioned by the Commission and, in fact, embodied in its own rules; and has enjoyed continued congressional approval. Even under the Silver test, however, approval of the Proposed Rules would be appropriate. The Proposed Rules are the minimum necessary to achieve the purposes of Section 17 of the Act.

used.[21] The language adopted by Congress requires the Commission to "endeavor" to take the least anticompetitive means of achieving the objectives of the Act.[22]

The Commission itself has recognized that Section 15 does not prohibit all anticompetitive rules or even always require the least anticompetitive approach. Section 15 applies the same test to the adoption of the Commission's own rules that it applies to the approval of SRO rules. When the Commission raised the minimum net capital requirement in 1978, it replaced a single capital requirement for all FCMs with a higher capital requirement for FCMs that were not members of any exchange than for FCMs that were exchange members. Many commentators objected to the distinction on the grounds that it was anticompetitive because it would drive small nonmember FCMs out of business and establish a substantial barrier to entry into the industry.[23] While the gap was narrowed in the final rules, the Commission made it clear that it had determined that the distinction was justified.

> The Commission recognizes that this distinction may have anticompetitive implications. However, Section 15

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[21] The Conference Report adopting Section 15 states:

> [T]he requirement that the Commission endeavor to take the least anticompetitive means of achieving the objectives of the Commodity Exchange Act is not intended to constitute any procedural roadblock to the Commission in regulating the futures trading industry, and separate proceedings to consider antitrust and anticompetitive matters are not required by the Commission in issuing any order, adopting any Commission rule or regulation, or in requiring or approving any bylaw, rule, or regulation of a contract market.

H. Rep. No. 1383, 93rd Cong., 2d Sess. 35 (1974).

[22] 7 U.S.C. § 19 (1974).

[23] 43 Fed. Reg. 39956, 39962 (1978).

> does not require the Commission to take the least anticompetitive regulatory approach if the purposes and objectives of the Act would be better served in some other way.[24]

NFA believes that the Proposed Rules maximize customer protection from FCM insolvency losses while minimizing the burden on competition. The history of insolvency losses in general, and the last four in particular, highlight the danger to customer funds held by thinly capitalized firms. A change is clearly necessary in order to provide a greater degree of customer protection. Increasing the capital requirement goes to the very heart of the problem by eliminating thinly capitalized firms.

The Proposed Rules also seek to minimize the burden on competition. While the Proposed Rules may cause some firms to stop operating as FCMs, the Proposed Rules will not force anyone out of the industry. An FCM which cannot raise the required capital can change its registration to that of an independent introducing broker.[25] As such, it will still be able to solicit and service customer accounts. The only major functions it will lose the ability to perform are holding customer funds and, as an adjunct, shielding the identity of its customers from the firms which carry its accounts. The holding of customers funds by such firms is precisely the evil that the Proposed Rules are designed to prevent, and the ability to shield the identity of its customers is a business convenience which is far outweighed by the need to provide greater protection of customer funds.

It should be noted that the SEC has proposed a similar change to its minimum net capital requirement.[26] Under that proposal, the minimum net capital requirement for broker/dealers holding customer funds would be raised to $250,000. The Federal Register release does not discuss the anticompetitive effect of

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[24] 43 Fed. Reg. 39956, 39962 (1978). The Commission does not appear to have considered the amount of the increase to be anticompetitive since that issue was not even addressed.

[25] NFA will work with the Commission to explore ways to streamline the process of changing a firm's registration from an FCM to an independent introducing broker as a result of the increase in the capital requirement.

[26] 54 Fed. Reg. 40395 (1989).

the SEC's proposal, so it would appear that the SEC believes, as NFA believes, that such concerns should not override the protection to be derived from an increase in minimum net capital requirements.

Alternate solutions to the problem of customer insolvency losses are inadequate. NFA does not believe that any other solution available to NFA is nearly as effective at balancing the interests of the customers in protecting their funds against the interests of the FCMs in fostering reasonable competition.

A number of comment letters suggested raising the minimum net capital requirement to some amount greater than $50,000 but less than $250,000. As discussed above, NFA believes that a minimum net capital requirement of less than $250,000 is inadequate. As noted above, volume has grown by 500% since the last time the minimum net capital requirement was raised, while the number of registered FCMs has remained relatively constant. This means that the average amount of business done by an FCM has increased substantially. During the same time, the intrinsic value of the dollar (as measured by its purchasing power) has decreased by 46%. In fact, if the industry continues to grow at its current rate, and if the value of the dollar continues to decrease, the minimum net capital requirement of $250,000 may need to be adjusted upwards in a few years.

Another alternative raised by many of the commentators is the adoption of a two-tiered minimum capital rule for Member FCMs. Under this solution, FCMs which carry customer funds would be subject to a higher minimum net capital rule than firms that do business on a fully disclosed basis.

The distinction between an FCM which does business on a fully disclosed basis and an independent introducing broker is largely illusory. The benefits to be derived from being a fully disclosed FCM rather than an independent introducing broker are mostly cosmetic: the public relations advantage of being able to advertise the firm as an FCM, and the ability to begin holding customer funds without having to register in a new category. NFA does not believe that these cosmetic advantages justify the creation of a separate capital requirement just for fully disclosed FCMs.

Two comments suggested raising the other prong of the minimum net capital requirement -- the percentage of segregated funds. This solution is overly broad because it tends to raise

the minimum net capital requirement for better capitalized firms which have not historically posed a significant threat of insolvency. If the minimum net capital requirement were changed to the greater of $50,000 or 10% of the funds required to be segregated, an FCM could still hold $500,000 in segregated funds without raising its capital requirement.

Finally, several commentators recommended utilizing a program of customer account insurance. As discussed in the Customer Account Protection Study,[27] an insurance program is an inefficient and unnecessary solution. It would cost more to administer than it is likely to pay out in claims, and it would take a long time to implement. More importantly, the primary cost of the insurance program is likely to be absorbed by the better capitalized firms, which do not have a history of insolvency losses, rather than by the thinly capitalized firms, which do have such a history. In contrast, raising the minimum net capital requirement places the cost on those firms which tend to create the problem.

The Proposed Rules are necessary to provide greater protection of customer funds in the event of an FCM insolvency. Furthermore, they are the least anticompetitive means of achieving this protection. Therefore, the mandate of Section 15 of the Act is met, and the Commission should approve the Proposed Rules, including the change to the minimum net capital requirement.

## VI. CONCLUSION

Notice of these changes is being sent to all NFA Member FCMs today (Notice # I-90-2). The Notice advises FCMs to be prepared to implement the changes 180 days from the date of the Notice. NFA believes that six months is an adequate period of time for affected FCMs to either increase their capital or convert their operation and registration to that of an independent introducing broker.[28]

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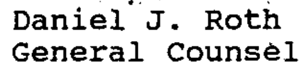
[27] Customer Account Protection Study, supra at 93-115.

[28] In this regard, we note that the Commission's 1978 change in the net capital requirement became effective 103 days after the final rules were published in the Federal Register (although non-exchange member FCMs were given an additional six months to raise the second $50,000).

NFA respectfully requests approval of the foregoing proposed amendments to NFA Compliance Rules 2-12 and 2-33 and to NFA Financial Requirements Sections 1, 6, and Schedule D, Section D3-d. NFA requests that the Commission declare the proposed amendments effective 180 days after the date of this letter or upon Commission approval, whichever is later.

Respectfully submitted,



Daniel J. Roth
General Counsel

DJR:jac

cc: Chairman Wendy L. Gramm
Commissioner Kalo A. Hineman
Commissioner Fowler C. West
Commissioner William P. Albrecht
Andrea M. Corcoran, Esq.
Joanne T. Medero, Esq.
Dennis P. Klejna, Esq.
Alan L. Siefert, Esq.
Susan C. Ervin, Esq.
Paul H. Bjarnason, Jr.
Lawrence B. Patent, Esq.

UNITED STATES OF AMERICA
**COMMODITY FUTURES TRADING COMMISSION**
2033 K Street, N.W.
Washington, D.C. 20581

August 27, 1990

Mr. Daniel J. Roth
General Counsel
National Futures Association
200 West Madison Street
Chicago, Illinois 60606

Re: Proposed amendments to National Futures Association Financial Requirements Sections 1 and 6 and Schedules B and C

Dear Mr. Roth:

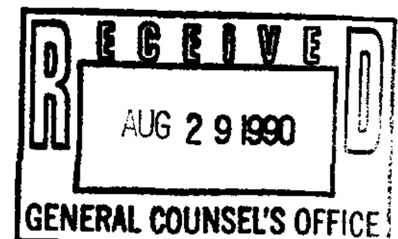
By letters dated January 25, 1990 and March 12, 1990, the National Futures Association ("NFA"), pursuant to Section 17(j) of the Commodity Exchange Act ("Act"), submitted to the Commission proposed amendments to NFA Financial Requirements Sections 1 and 6; Schedule B, Section B2-a(ii)(A); and Schedule C, Sections C1-b(vi)(C), C1-b(vii), C1-b(viii)(A), C2-b, C2-e, and C2-f. The Commission understands that NFA intends to implement these rule amendments with respect to existing futures commission merchants ("FCMs") on December 31, 1990. The Commission further understands that any firm seeking FCM status after Commission approval of the proposed rules, but before December 31, 1990, would be required to meet the new minimum adjusted net capital requirement.

Please be advised that on this date the Commission has approved the above-referenced rule amendments pursuant to Section 17(j) of the Act.

Sincerely

Jean A. Webb

Jean A. Webb
Secretary of the Commission



UNITED STATES OF AMERICA
**COMMODITY FUTURES TRADING COMMISSION**
2033 K Street, N.W.
Washington, D.C. 20581

July 17, 1990

Daniel J. Roth, Esq.
General Counsel
National Futures Association
200 West Madison Street
Chicago, Illinois 60606

Re: The National Futures Association's Proposed New Financial Requirements Schedule D, Section D3-d and Compliance Rule 2-33 and Proposed Amendment to Compliance Rule 2-12

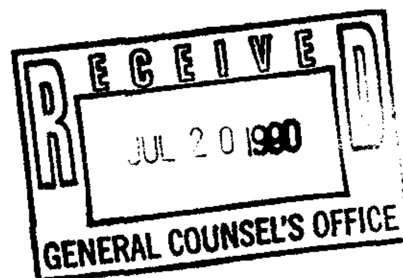
Dear Mr. Roth:

By letter dated January 25, 1990, the National Futures Association ("NFA") submitted to the Commission pursuant to Section 17(j) of the Commodity Exchange Act ("Act") proposed new Financial Requirements Schedule D, Section D3-d and Compliance Rule 2-33 and a proposed amendment to Compliance Rule 2-12.

Please be advised that on this date the Commission has approved the above-referenced proposed new rules and rule amendment under Section 17(j) of the Act.

Sincerely,

Jean A. Webb
Secretary of the Commission



NFA NATIONAL FUTURES ASSOCIATION
200 W. MADISON ST•CHICAGO, IL•60606•(312) 781-1300

May 22, 1990

**VIA AIRBORNE EXPRESS**

David Van Wagner, Esq.
Special Counsel
Division of Trading & Markets
Commodity Futures Trading Commission
2033 K Street, N.W.
Washington, D.C. 20581

Re: National Futures Association: Proposed Amendments to NFA Compliance Rules 2-12 and 2-33 and to NFA Financial Requirements Sections 1, 6, and Schedule D, Section D3-d

Dear Mr. Van Wagner:

As you requested over the telephone yesterday, May 21, 1990, enclosed are copies of the comment letters received by NFA in response to NFA's August 31, 1989 Notice to FCM and IB Members (#I-89-19) seeking comments on proposed changes to NFA's financial and reporting requirements. If you have any questions, or if I can be of any further assistance, please contact me.

Very truly yours,

Kathryn Page Camp
Assistant General Counsel

KPC:jac(Ltrs\VWagner.KPC)

Enclosures