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August 1, 2014

**BUSINESS CONFIDENTIAL**

BY COURIER

Office of Foreign Assets Control  
Attn: Ms. Rachel Nagle  
Sanctions Compliance and Evaluation  
U.S. Department of the Treasury  
1500 Pennsylvania Avenue, N.W.  
Washington, D.C. 20220

Dear Ms. Nagle:

Thank you for taking the time to discuss the regulations regarding Ukraine related sanctions (31 CFR Part 589) (the “**Regulations**”) and the applicability of the Regulations to transactions in futures, options on futures contracts and cleared swaps (collectively, “**cleared derivatives**”).<sup>1</sup> As the leading trade association for the cleared derivatives markets worldwide, FIA appreciates this opportunity to provide additional information concerning the cleared derivatives markets that may be useful as you continue to develop implementing Regulations.

We understand that the Regulations would not permit a futures commission merchant (“**FCM**”) to liquidate the accounts of customers that are subject to asset-blocking sanctions, absent either a general or specific license that would permit such liquidation through offsetting transactions. As explained below, however, the financial integrity of the cleared derivatives markets depends on the ability of an FCM (i) to collect required margin from its customers within the time prescribed under applicable rules, (ii) to transmit required margin to the derivatives clearing organization (“**DCO**”) within the prescribed time under applicable rules and, and (iii) to liquidate in an orderly manner the positions of any customer that is unwilling or unable to meet these margin obligations. As OFAC considers revisions to the Regulations, therefore, we request OFAC to include a general license that would authorize an FCM to liquidate the open positions of a customer that is the target of sanctions under the Regulations or that would authorize a (“**DCO**”) to liquidate the open positions of a customer in the event the FCM is in default. Subject to offsetting or reimbursing the amounts owed to the FCM [and/or DCO], we understand that the liquidated proceeds would be required to be held in a blocked, interest-bearing account pursuant to the Regulations.

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<sup>1</sup> The rules governing the treatment of foreign futures is similar, but not identical, to those discussed in this letter but we recommend that OFAC include foreign futures within the definition of “cleared derivatives” in any regulations pertaining to futures.

## Discussion

Under the Commodity Exchange Act (“CEA”), the rules of the Commodity Futures Trading Commission (“Commission”), and the rules of the several designated contract markets (“DCMs”), Swap Execution Facilities (“SEFs”) and related DCOs registered with the Commission, any customer that wishes to enter into transactions in cleared derivatives must maintain an account with an FCM, which acts as agent and guarantor for its customers in the execution and clearing of cleared derivatives.<sup>2</sup> The obligation of the FCM to guarantee customers’ trades assures the financial integrity of the markets and protects market participants from potential loss. Once a contract has been accepted for clearing by the relevant DCO, the customer’s clearing FCM assumes responsibility to the DCO as guarantor for its customer’s open positions.<sup>3</sup> In this regard, therefore, a clearing FCM is liable to the relevant DCO for the payment of initial margin owing when a trade is initiated and, further, is responsible for the payment of any daily variation margin that may be required. If a customer is unwilling or unable to meet a margin call to its FCM, or the FCM is unable to accept the margin payment from its customer, the FCM must nonetheless make all margin payments owing to the DCO until the contract is liquidated or the contract expires.<sup>4</sup> The relevant DCO will automatically debit the bank account of such clearing FCM each day for all margin due irrespective as to whether every underlying customer has met its margin call to the FCM for their respective positions. Under CFTC regulations, an FCM is not permitted to use one customer’s funds to meet the margin obligations of another. Thus, if one customer is unable to deposit funds and the position cannot be closed out due to the Regulations, the FCM must provide its own funds to the DCO to meet the margin requirement and must continue to do so until the open position expires.<sup>5</sup> Moreover, to the extent that the customer’s account is under-margined, the FCM must also take a charge against its own capital.

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<sup>2</sup> An FCM is broadly defined as an entity that (i) is engaged in soliciting or accepting orders for transactions in cleared derivatives, and (ii) in connection therewith, accepts any money, securities, or property (or extends credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result therefrom.

<sup>3</sup> For example, CME Rule 8G05 provides, in relevant part, that, with respect to interest rate swaps (“IRS”):

The IRS Clearing Member shall be deemed the principal to the IRS Contract when cleared by such IRS Clearing Member for its own proprietary account and shall be deemed a guarantor and agent of the IRS Contract when cleared by such IRS Clearing Member for the account of an affiliate or customer of such IRS Clearing Member.<sup>3</sup>

Regulation 3(b) of LCH.Clearnet Ltd.’s FCM Regulations provides:

Notwithstanding any other provision of these FCM Regulations, with respect to FCM Transactions involving an FCM Client or an Affiliate cleared by an FCM Clearing Member as FCM Contracts, such FCM Clearing Member shall act solely as agent of its FCM Clients and Affiliates in connection with the clearing of such FCM Contracts; provided, that each FCM Clearing Member shall remain fully liable for all obligations to the Clearing House arising in connection with such FCM Contracts.

<sup>4</sup> In these circumstances, an FCM could be deemed to be extending credit to the customer, which is prohibited under CFTC Rule 1.30.

<sup>5</sup> This could have a significant effect on the FCM’s liquidity which in turn has a negative effect on the FCM’s remaining customers, including US entities.

Customer open positions may only be closed by liquidation in an orderly fashion, taking into account particular circumstances of the position and the relevant market, in accordance with applicable SEF, DCM or DCO rules. Neither the Commission's rules nor SEF, DCM or DCO rules authorize an FCM to simply close a defaulting customer's positions without entering into a liquidating transaction which clears at the DCO. Requiring open positions to be closed by liquidation on or subject to the rules of the DCM or SEF assures that the customer receives a market price and, more broadly, assures market integrity.

The inability of an FCM to liquidate in an orderly manner the open positions of a customer that is unwilling or unable to meet margin payments within the time required, therefore, exposes the FCM to significant losses. This is particularly true in volatile market conditions. If a contract is allowed to expire and settles by physical delivery of the underlying commodity, the FCM is exposed to further risk, as the FCM must either acquire and deliver the commodity under the terms of the cleared derivative if the customer had a short position, or take possession of the commodity following delivery, if the customer had a long position. FCMs may not be in a position to take such physical delivery and may have to sell the resulting commodity at a loss. Depending on the size of those losses, the FCM may be unable to remain in business, to the potential detriment of its other customers and the markets generally. In the event that a large FCM or multiple FCMs were unable to liquidate positions and incurred significant losses, this could create systemic risk issues across the financial markets.

To protect against the potential for such losses, the standard agreement between an FCM and its customers provides that the failure of a customer to make any payment to the FCM when due is an event of default under the agreement and authorizes the FCM, *inter alia*, to liquidate, close-out, or terminate any open positions. Following liquidation of all open positions and the payment of any sums owing to the FCM, the balance is held in the customer's account pending further instructions. In connection with such liquidation, the agreement's terms also permit the FCM to mitigate or hedge the risk of such defaulting positions by possibly adding new positions if liquidating would cause significant market disruption (such as where the customer holds a significantly large position in a particular contract).

Permitting an FCM to liquidate the open positions of a customer that is subject to the Regulations, therefore, is consistent with the purposes of the Regulations and assures the financial integrity of the cleared derivatives markets. Any funds owing to the customer as a result of liquidation would be placed in a blocked, segregated and interest-bearing account under the Regulations and would not be returned to the customer except in compliance with applicable sanctions.

Moreover, in the absence of a market emergency or the potential failure of the FCM, there is no basis under the rules of a SEF, DCM or DCO for a SEF, DCM or DCO to take control of a defaulting customer's positions. However, if the FCM fails, the DCO may need to liquidate the portfolios of both the defaulting FCM and its customer in order to protect the market. As such, we suggest that any OFAC license allow the DCO to liquidate the customer position in this circumstance. As discussed earlier, a clearing FCM is the guarantor of all of its customers'

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obligations. As such, the DCO looks only to the FCM to meet all margin requirements. The failure of an FCM's customer to pay any margin owing to the FCM does not terminate the obligation of the FCM to pay margin to the DCO for the customer's position.

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Based on the foregoing, we respectfully request that OFAC amend the Regulations to include a general license that would authorize an FCM to liquidate the open positions of a customer that is the target of sanctions under the Regulations, or that would authorize a DCO to liquidate the open positions of a sanctioned customer in the event the FCM is in default, provided that the proceeds of any such liquidation, net of any amounts owing to the FCM and/or DCO, would be held in a blocked, interest-bearing account under the Regulations.

We trust you will find the information set out above helpful. If you have any questions or need any additional information regarding the matters discussed herein, please contact Allison Lurton, at [alurton@fia.org](mailto:alurton@fia.org) or (202)466-5460.

Respectfully yours,

A handwritten signature in black ink, appearing to read "Allison Lurton", written in a cursive style.

Allison Lurton  
Senior Vice President and Deputy General Counsel