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CFTC Adopts Final Rules on Protection of Cleared Swaps Customer Collateral

On January 11, 2012, the Commodity Futures Trading Commission ("CFTC") approved final rules that adopt a new client margin segregation model for cleared swaps that is intended to provide greater protection than the existing futures segregation model (the "LSOC Rules"). The LSOC Rules, which implement Section 724 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act")[1], will apply to all registered futures commission merchants ("FCMs") and derivatives clearing organizations ("DCOs") that clear swaps for customers.

The LSOC Rules represent a key step toward implementing a mandatory clearing framework for swaps under the Dodd-Frank Act, and result from a debate among regulators, clearing organizations, FCMs and other market participants about the appropriate level of protection for customer assets in cleared swaps and conversely, the appropriate level of mutualization of risk across customers. In their final form, the LSOC Rules are intended to reduce or eliminate so-called "fellow-customer risk", that is, the risk that margin posted by one customer of an FCM will be used to cover a loss caused by a different customer of that FCM in the event of the failure of the FCM. The LSOC Rules accomplish this principally by limiting the ability of a DCO to use customer margin posted by non-defaulting customers of a failed FCM to satisfy losses caused by defaulting customers. The LSOC Rules nonetheless permit the commingling of margin of different cleared swaps customers at the DCO, and the rules do not limit the mutualization of customer losses from investment losses, custodial failures, fraud or other causes.

Compliance with the LSOC Rules, which is expected to involve considerable implementation work by DCOs, FCMs and other market participants, will be required by November 8, 2012.

[1] Section 724(a) of the Dodd Frank Act amended the CEA by inserting a new section 4d(f), which requires each FCM and DCO to (i) hold cleared swaps customer collateral in an account (or location) that is separate from the property belonging to the FCM or DCO, and (ii) not use the collateral of one cleared swaps customer to cover the obligations of another cleared swaps customer or the obligations of the FCM.

Background

The customer property segregation rules for futures contracts, which are set forth in Section 4d of the Commodity Exchange Act ("CEA") and CFTC Rules 1.20-1.30, generally permit FCMs and DCOs to commingle the property of multiple customers in an omnibus segregated account and permit a DCO to use all of the customer property posted to it to cover losses on customer positions carried by a defaulting FCM. In the context of the clearing of swaps, and in light of concerns stemming from the Lehman Brothers insolvency and the developing practice of margin segregation for uncleared swaps, the CFTC in December 2010 issued a concept release and requested comments on three potential alternative models to address the protection afforded to the collateral of cleared swaps customers in addition to the existing futures model (the "Futures Model"). The three alternative models included (i) the "legal segregation with operational commingling model" (also referred to as the "LSOC Model" or (somewhat inaccurately) as "complete legal segregation"), which was the model ultimately adopted, (ii) the "physical segregation model" ("Physical Segregation Model"), whereby each FCM and DCO would maintain separate accounts for each cleared swaps customer and would not be allowed to commingle or use collateral of different cleared swaps customers, and (iii) the "legal segregation with recourse model" ("Moving Customers to the Back of the Waterfall Model"), which is similar to the LSOC Model but would allow a DCO to access the collateral of non-defaulting cleared swaps customers after application of its own capital and guaranty fund contributions. Based on the comments received by the CFTC from various market participants and industry groups, many FCMs and some DCOs favored the current Futures Model and noted that either the LSOC Model or Physical Segregation Model would entail significant increases in clearing costs and margin levels, while many buy-side firms provided comments which supported the LSOC Model or the Physical Segregation Model to afford the maximum possible protection. In June 2011, the CFTC formally proposed the LSOC Model but continued to seek comments on the costs and benefits of the LSOC Model while continuing to evaluate the Moving Customers to the Back of the Waterfall Model.

LSOC Model

Similar to current practice for futures customer collateral under the Futures Model, the LSOC Model allows FCMs and DCOs to commingle the collateral of their cleared swaps customers in a segregated omnibus customer account pre-bankruptcy. However, FCMs and DCOs may not (i) commingle cleared swaps collateral with other property or collateral (including futures margin or property and collateral belonging to the FCM or DCO) or (ii) use the collateral of one cleared swaps customer for the benefit of any other customer. As an additional protective measure that does not exist with respect to futures, FCMs must send information about the identities of their cleared swaps customers and the required amount of cleared swaps collateral held at the DCO that is attributable to each cleared swaps customer at least once each business day. This is intended to permit the DCO to determine which customer's margin may be used in the event of an FCM and customer default (and to prevent use of margin attributable to other, non-defaulting customers).

In furtherance of the new segregation requirements, FCMs will be required to post to DCOs the gross margin required by the DCO of each of the FCM's cleared swaps customers, instead of the net margin obligation of all of the FCM's cleared swaps customers in the aggregate.[2]

[2] 17 C.F.R. § 39.13(g)(8) (2011).

Mitigation of Fellow-Customer Risk

The CFTC noted that in adopting the LSOC Rules, it was seeking to enhance protection for, and facilitate the portability of, the cleared swaps and associated collateral of cleared swaps customers. Specifically, the CFTC was concerned with limiting "fellow customer risk" that causes mutualization of risk among customers. Because of the operation of Section 766(h) of the Bankruptcy Code and the CFTC Part 190 regulations applicable to FCM insolvencies, shortfalls in customer property carried by a bankrupt FCM are shared among customers of the relevant account class on a pro rata basis (which is sometimes referred to as mutualization of the risk across customers). In some cases, a default by a cleared swaps customer could result in a loss to the FCM that might in turn cause the FCM to default to the DCO (a "double default"). Under the current rules applicable to futures, a DCO would be permitted to use all of the collateral in the FCM's customer account to meet a loss in such FCM's customer account, without regard to which customer supplied the collateral or caused the default. The remaining customer property would be shared among all customers pro rata based on their net equity claims.

Under the LSOC Model, by contrast, in the event of a double default, the DCO would only be permitted to access the collateral of the defaulting cleared swaps customers of the defaulting FCM (as well as resources of the FCM itself and other default resources) and would not have access to the collateral posted by non-defaulting cleared swaps customers. As a result, a default by one customer should not cause a shortfall in the customer account that would result in mutualization of loss to non-defaulting customers.

The LSOC Model is also intended to make it easier for the DCO and/or trustee of a defaulting FCM to port a cleared swap customer's portfolio of positions to a solvent FCM because the DCO would have information current within the last business day connecting cleared swaps customers to their portfolios of positions. It is also less likely that there would be a shortfall in customer funds, which will facilitate moving associated margin along with positions. The benefits of the LSOC Model in this regard depend to a great extent on the maintenance by the DCO and FCM of accurate books and records so as to clearly identify which cleared swaps customers may have contributed to the FCM's default to the DCO.

Also, it bears noting that the LSOC Model does not provide protection against other risks that may result in mutualization of losses across cleared swap customers. As noted above, Section 766(h) of the Bankruptcy Code requires the pro rata distribution of customer property in the relevant account class. Accordingly, if there are investment losses in the pool of swap customer collateral, and the FCM defaults, those losses would be shared pro rata among swap customers, even if those customers have not in any way defaulted. A similar result would apply to losses to customer property resulting from operational risks, negligence, misallocation, fraud, custodian failure and similar events. In this regard, the LSOC Model is not different from the Futures Model.

For this reason, as noted below, many market participants had preferred the Physical Segregation Model, under which customers in theory would not be subject to mutualization for these additional risks. Questions had arisen, however, as to the interaction of such a framework with Section 766(h) of the Bankruptcy Code, as well as significant operational and cost considerations.

Third Party Custodial Accounts

A topic that caught many market participants by surprise is that the CFTC confirmed that, subject to certain conditions described below, in lieu of posting collateral directly to the FCM, cleared swaps customer collateral may be held in a limited type of third-party safekeeping account. Specifically, the LSOC Rules provide that if an FCM uses, or allows the use of, a third-party safekeeping account, such FCM must comply with all of the conditions for such accounts set forth in the CFTC's Financial and Segregation Interpretation No. 10 on the Treatment of Funds Deposited in Safekeeping Accounts ("Segregation Interpretation No. 10"), as originally issued in 1984.[3]

In practice, such accounts may be of limited use to market participants. Under Segregation Interpretation No. 10, property in these accounts constitutes customer property under the applicable bankruptcy rules, and so would not avoid pro rata distribution to the extent it would otherwise apply. In addition, the conditions of the interpretation require that the account be maintained in the FCM's name with largely unfettered rights of access by the FCM, and no direct right of access by the customer without the FCM's consent. Because margin in a safekeeping account cannot be provided to the DCO, the FCM will have to separately fund the margin requirement at the DCO, which may increase the costs of these arrangements. This is especially likely to be true given the new requirement that DCOs collect gross margin for customer positions.

Investment of Customer Collateral

The LSOC Rules provide that cleared swaps customer collateral may only be invested pursuant to CFTC Regulation 1.25,[4] which also governs the investment of customer property of futures customers. The LSOC Rules do not, however, limit the types of collateral that a cleared swaps customer may post. DCOs and FCMs may limit the types of collateral that they accept, however. As a result, many FCMs may provide customers with collateral transformation services at an additional cost where cleared swap customers would post collateral to the FCM that would be an ineligible form of collateral under DCO rules, and the FCM would "transform" the collateral received into a form that would be acceptable under DCO rules.

Conclusion

As adopted, the LSOC Rules cover cleared swaps only, and not futures. While the existing omnibus account model for futures remains the same at this time, the CFTC has directed the CFTC staff to look into the possibility of adopting the LSOC Model for the futures market as well. The CFTC noted that any additional protections for futures customers would likely be built on the LSOC Model.

[3] Between 1984 and 2005, the CFTC permitted the use of third-party custodial accounts for futures margin by pension plans and investment companies registered under the Investment Company Act of 1940 pursuant to Segregation Interpretation No. 10. In 2005, an Amendment to Segregation Interpretation No. 10 provided that, with limited exceptions, FCMs would not be in compliance with the requirements of the CEA if they held customer funds in a third-party custodial account.

[4] In December 2011, the CFTC adopted amendments to Rule 1.25 which, among other things, restricted FCMs and DCOs from investing in municipal obligations, corporate notes, and foreign sovereign debt and from engaging in repurchase and reverse repurchase transactions involving customer property with affiliates and so-called "internal repos" within the FCM.

In addition, the CFTC noted that a number of commenters have proposed alternative arrangements that would provide individual protection for collateral belonging to cleared swaps customers and futures customers that are willing and able to bear the associated costs. The CFTC is considering seeking comment on a proposal to allow individual protection of client assets, but noted that these proposals raise important cost, risk management and insolvency issues. We will continue to update clients as these proposals develop.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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