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Memorandum

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CFTC Adopts "Legal Segregation with Operational Commingling" Model for Treatment of Cleared Swaps Collateral

By Julia Lu and John A. Clark

After the failures of Lehman Brothers and MF Global, market participants should appreciate the importance of understanding the whereabouts of their collateral and all possible competing claims to that collateral – regardless of whether it is posted to support commodities, swaps or futures trading, or held in custody by a prime broker or other financial institution. While there are a multitude of rules and regulations that govern a customer's rights in collateral supporting brokerage and trading relationships, including the federal securities laws, the Securities Investor Protection Act and the Commodity Exchange Act, there had not been specific rules governing collateral for swaps trading until the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") in 2010.

On January 11, 2012, the Commodity Futures Trading Commission ("CFTC") announced final rules implementing certain statutory requirements of the Dodd-Frank Act regarding the segregation and limited use of collateral posted by market participants as margin for cleared swaps. The CFTC's announcement concluded a long-running (and sometimes heated) debate among dealers, clearing organizations, end-users and regulators concerning the allocation of costs, safeguards and risks affecting customers' cleared swaps margin. In their final rules, the CFTC adopted a segregation model referred to as "complete legal segregation" or "LSOC" (short for "legal segregation with operational commingling"), which the agency believes strikes the most appropriate balance between competing interests of different participants in the industry. The CFTC expects these rules to facilitate the transfer of customer positions and limit non-defaulting customers' exposure to their swap dealer and to other customers who may default.

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BACKGROUND

Historically, over-the-counter swap contracts have been executed under an ISDA Master Agreement between two counterparties – e.g., a derivatives dealer and one of their financial or commercial end-user customers. Following the implementation of the Dodd-Frank Act's mandatory clearing requirements for certain swaps,[1] however, end-users will be required to trade clearable swaps under clearing agreements with dealers that are members ("futures commission merchants," or "FCMs," in regulatory parlance) of a derivatives clearing organization ("DCO").[2] FCMs, in turn, will clear

1 For a general discussion about central clearing of derivatives transactions, please see a previous RK&O article, *Prepare for the Clearing Environment*, December 3, 2010, *available at* http://www.rkollp.com/newsroom-publications-139.html.

2 FCMs include futures brokers, although these final rules do not apply to FCMs in that capacity or to collateral posted in relation to futures contracts. Customer collateral posted in respect of cleared futures contracts are subject to separate CFTC rules regarding its use by FCMs and DCOs, though certain CFTC commissioners have expressed interest in extending aspects of the LSOC model to the futures market in response to the failure and loss of customer collateral by MF Global, a registered FCM.

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such swaps trades by novating swap contracts to the DCO and by essentially guaranteeing their end-user customers' performance to the DCO. In connection with such trades, end-users will post initial and variation margin to FCMs based on each end-user's portfolio of trades with its FCM in order to secure the end-user's prompt payment of any net loss on their portfolio. Likewise, each FCM will post collateral to the relevant DCO for such trades in order to secure the FCM's payment of any potential net loss on the FCM's trades cleared through the DCO.[3]

Segregation of cleared swap collateral, like the central clearing regime itself, is largely designed to mitigate systemic risk. A number of inter-related issues must be considered and competing interests balanced in connection with the choice of a collateral segregation model. Some of the issues and interests advanced in the CFTC's releases and market participants' comment letters included: (i) reducing "fellow customer risk," or the risk that a DCO would need to access the collateral of non-defaulting customers to cure an FCM default (caused by another customer's default); (ii) improving the portability of customers' accounts from the defaulted FCM to solvent FCMs;[4] (iii) preserving the operational efficiency of each FCM in the absence of any FCM or customer default;[5] (iv) ensuring the solvency and continuity of operations of a DCO in the event of a related FCM or customer default;[6] and (v) mitigating "investment risk," or the risk that an FCM's customers will bear the loss of any negative returns on collateral invested by the FCM.

THE LSOC MODEL

Under the LSOC model, collateral posted by end-users in support of cleared swap trades will be "segregated" on the books and records of both the FCM and the DCO from the rights and obligations of the FCM and DCO and from those of non-cleared swap customers. Operationally, however, each FCM will be permitted to "commingle" the segregated collateral of all the cleared swap customers (but only such customers) in (i) a single collateral account for the benefit of the DCO (containing collateral amounts required by the DCO) and (ii) a single collateral account for the benefit of the FCM (generally containing excess collateral amounts).[7] FCMs will not be permitted to use one customer's collateral to support any other customer's obligations, and DCOs will not be permitted to use any FCM's collateral to support any other FCM's obligations. DCOs will also be prohibited from using any collateral posted by an FCM which has been allocated to non-defaulting customers.

Importantly, the LSOC rules also require each FCM, during the course of its relationship with a DCO, to prepare and deliver to the DCO, at least daily, "information sufficient" to identify the portfolio of rights and obligations belonging to each of the FCM's customers whose trades are cleared through the DCO. If an FCM defaults, a DCO is entitled, and obligated, to rely upon the defaulted FCM's last received portfolio report in order to allocate all collateral posted to the DCO among swap customers whose trades were cleared through the defaulted FCM.

Although customers' collateral remains subject to some

3 Note that, in general, the structure of the end-user, FCM and DCO relationship in the cleared swaps market will closely resemble the structure that already exists in the cleared futures market.

4 In the event of an FCM default, if open positions cannot be "ported," or transferred, to other FCMs, customers would be required to terminate their contracts, close-out their positions, liquidate collateral and reestablish trades with new counterparties, which together is generally a much more expensive and time-consuming process compared to porting. Widespread close-outs can lead to impaired asset values as large sums of collateral are liquidated throughout the financial system, and, in turn, to more defaults by other market participants. On the other hand, if the non-defaulting customers' open positions can be ported to another FCM in the event of an FCM default, then normal trading can resume without undue interruption and without the devastating domino effect of a systemic proportion.

5 For example, some clearing houses advocated for what is known as the "futures model," under which the collateral of cleared swap customers would be recognized by a DCO on an omnibus basis, with no records of individual customer's rights and obligations.

6 Under the futures model and the "legal segregation with recourse model," upon the default of the FCM (caused by the default of its customers), the DCO is permitted to access non-defaulting customers' collateral.

7 Operational commingling contrasts to the "physical segregation model," which would require each customer's collateral to be held in a separate account. Physical segregation is sometimes used under existing ISDA Master Agreements in which the parties agree to hold posted collateral in a separate collateral account (often at an account maintained by a third-party custodian). This method will continue to be available under the Dodd-Frank Act's regime governing uncleared swaps for those end-users that elect it. The CFTC determined, however, that mandatory physical segregation would be too costly on an operational basis for cleared swap collateral held at the DCO level.

investment risk under LSOC, both FCMs and DCOs will only be permitted to invest in certain types of assets, as enumerated in CFTC regulation 1.25 (primarily U.S. government obligations, U.S. government-backed obligations and state obligations, as well as certain corporate debt and money market funds subject to various risk management requirements).

Here is a (greatly simplified) overview of how LSOC would work in common default scenarios:

- **FCM failure (e.g., bankruptcy due to financial difficulty) without a shortfall of swap customer collateral:** Customers' collateral that is segregated will not be used to satisfy a failed FCM's obligations. Instead, customer positions (including related collateral) may be ported by an FCM (or its trustee or receiver) to a transferee FCM.[8] Further, a DCO should be able to efficiently allocate customer collateral to their respective trades and port cleared positions (and such collateral) because each of its FCMs are required to provide daily portfolio reports to the DCO before any failure, and the DCO should be less reliant on an FCM for information and cooperation following its failure.[9]
- **FCM failure with a cleared swaps customer account shortfall due to operational negligence, malfeasance or extraordinary losses on invested collateral:** Where an FCM has failed and there is a shortfall in the cleared swap customer account due to reasons other than customer margin defaults, the Bankruptcy Code requires and the new rules maintain that losses on posted cleared swap customer property be shared pro rata by all cleared swap customers. The subsequent transfer (or liquidation) of positions should proceed in the same way as above.
- **FCM failure due to loss incurred by a customer which exceeds both the customer's collateral and the FCM's ability to pay:** A so-called "double default" may occur when one or more cleared swap customers default on their swap contract obligations to an FCM and the FCM simultaneously is unable to meets its obligations to the DCO that clears such swaps (likely as a result of the customers' default). In this case, the DCO would allocate all cleared swaps collateral posted by the failed FCM using the most recent portfolio report information, and the DCO would be permitted to apply all collateral attributable to customers that are in default to any FCM amounts owing to the DCO.[10] The DCO would not have recourse to the collateral allocated to customers who had not defaulted on their swap trades and related margin calls. These non-defaulting customers' positions (and collateral) would be available for transfer to solvent FCMs (or liquidation), as above.

LSOC rules technically will become effective as of the 60th day from their publication in the Federal Register. They likely will be of most practical importance to an end-user only following registration of one or more DCOs that clear swaps of interest to the end-user and to the extent the CFTC requires mandatory clearing of such swaps.

CONCLUSION

The CFTC believes the new LSOC rules will (i) enhance the portability of non-defaulting customer positions from failed FCMs to solvent FCMs and (ii) afford certain protections (and allocate a few related risks) to customers' posted collateral in the event of a default or defaults by various participants in the clearing relationship.

Collateral segregation rules are a cornerstone of the central swap clearing regime. Inasmuch as these rules

8 A DCO may also liquidate the positions of customers and their collateral and deliver the proceeds to the failed FCM's trustee, as necessary.

9 It should be noted that where portfolio reports themselves are improperly produced and delivered, a DCO's ability to properly allocate collateral may be impaired. As the failure of MF Global (among others) has demonstrated, proper recordkeeping and reporting operations may be compromised during times of distress.

10 In a double default, should the allocated collateral of any defaulting customers (in addition to certain other assets posted by the FCM for its own account) be less than the trade losses, the DCO itself must cover the shortfall out of its own capital (or from any guarantees or reserve funds provided by the syndicate of FCMs that clear through the DCO, to the extent available).

are the "state-of-the-art" methodology in the protection of customers and reduction of systemic risk, they may potentially become the prototype for changes to customer collateral segregation rules in similar trading markets, for example, futures. More immediately, the CFTC's adoption of these rules[11] will serve as a basis for the DCOs' rules and procedures in respect of cleared swap margining and default management. An end-user will need to carefully study the rules of the relevant DCO in order to acquire a detailed and complete understanding of the process both as an operational matter and in a default scenario.

QUESTIONS

If you have questions regarding the matters discussed in this memorandum, please call your usual contact at Richards Kibbe & Orbe LLP or one of the persons listed below.

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11 These rules, of course, apply to swaps as regulated by the CFTC. Corresponding rules applicable to security-based swaps, regulated by the Securities and Exchange Commission, are yet to be adopted.