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# CFTC Adopts Final Rules Governing Protection of Cleared Swaps Customer Contracts and Collateral

Today, the Commodity Futures Trading Commission (CFTC) published in the Federal Register new requirements for futures commission merchants (FCMs) and derivatives clearing organizations (DCOs) when handling customer collateral pledged as margin for cleared swaps. The rules, adopted by a 4-1 vote, will impose a regime of legal segregation with operational commingling (known as LSOC or Complete Legal Segregation). LSOC builds on the segregation framework that currently applies to futures and imposes additional requirements and prohibitions intended to protect those customers from losing collateral as a result of the default of a fellow customer.

Under LSOC, an FCM or DCO may commingle swap customers' funds in a single account as is allowed for futures. However, both the FCM and the DCO must separately account for each swaps customer, ensure that the customer account is separate from any account holding FCM, DCO or non-swaps customer property, and may not use a swap customer's funds to cover the default of another customer. LSOC does not alter the *pro rata* distribution of customer funds called for by the U.S. Bankruptcy Code in the event of an FCM or DCO bankruptcy.

FCMs and DCOs must implement LSOC for cleared swaps customer accounts by November 8, 2012. The remainder of the final rules, which amend existing definitions and deadlines in the bankruptcy provisions under the Commodities Exchange Act (CEA) that are applicable to FCM and DCO insolvencies, are effective April 9, 2012.

## Statutory Background

Section 724 of the Dodd-Frank Act amended Section 4d of the CEA, which for years has provided statutory protections of futures customer funds by FCMs and DCOs.[1] The new provision applies these protections to swaps, requiring that FCMs and DCOs hold customer collateral in an account or location separate from their own property, forbidding an FCM from using the collateral of one customer to cover the obligations of another customer, and prohibiting the use of customer collateral to pay for the obligations of the FCM or DCO.[2]

## What is complete legal segregation and how is it different than current collateral treatment for futures?

LSOC applies only to cleared swaps and imposes different collateral segregation rules than apply to futures. Under the rules for futures (the Futures Model), the FCM maintains information about each individual customer's collateral separately in its books and records, but all customer collateral is commingled in a single account. The FCM may not commingle any customer funds with its own funds.[3] The DCO views each FCM's account on an omnibus basis and does not receive information about each

1 Although CEA § 4d generally applies to FCMs, CEA § 4d(f)(6) requires DCOs to treat funds deposited by an FCM as belonging only to that FCM and its customers.

2 CEA § 4d(f)(2)

3 77 Fed. Reg. 6339.


*If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.*

**Mark D. Young**
Washington, D.C.
202.371.7680
mark.d.young@skadden.com

**Maureen A. Donley**
Washington, D.C.
202.371.7570
maureen.donley@skadden.com

**Brian M. Duncan**
Washington, D.C.
202.371.7396
brian.duncan@skadden.com

**Timothy S. Kearns**
Washington, D.C.
202.371.7244
timothy.kearns@skadden.com


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1440 New York Avenue, NW,
Washington, D.C. 20005
Telephone: 202.371.7000

Four Times Square, New York, NY 10036
Telephone: 212.735.3000

WWW.SKADDEN.COM

individual customer of an FCM.[4] If a futures customer were to default in a manner that causes the FCM to default on its obligations to the DCO (a double default), the DCO can access all customer collateral posted to the DCO by the defaulting FCM to resolve the deficit before the DCO must apply funds from its guaranty fund or its own capital.[5] This possibility that one customer's collateral could be used to cover the default of another customer is known as fellow-customer risk.

The LSOC model will require both the FCM and DCO to track in their respective books and records each individual customer's cleared swaps accounts and relevant collateral separately. Each customer's collateral must be kept separate from the FCM's and DCO's funds and the funds of non-cleared swaps customers. For operational purposes, however, the FCM and DCO may commingle the cleared swaps collateral in one account, so long as the account does not contain the collateral of non-cleared swaps customers or FCM or DCO property.[6]

Under LSOC, in the event of a double default, the DCO may access the collateral of the defaulting cleared swaps customers, but not the collateral of nondefaulting cleared swaps customers. But, nondefaulting cleared swaps customers will still be subject to the *pro rata* distribution of customer property imposed by the Bankruptcy Code. Accordingly, while the DCO cannot use the collateral of a nondefaulting customer under LSOC, if an FCM has insufficient customer funds when it enters bankruptcy, a nondefaulting customer may suffer a loss from the haircut necessary to make the distribution to customers *pro rata*.[7]

## What risks is LSOC intended to mitigate?

The CFTC identifies the purpose of the rulemaking as protecting Cleared Swaps Customer Collateral from fellow-customer risk,[8] although the CFTC acknowledges that LSOC does not eliminate fellow-customer risk entirely.[9] In the event of a double default, LSOC shifts the risk of loss to the DCO and nondefaulting clearing members through the guaranty fund and potential assessments for additional guaranty fund contributions.[10]

The CFTC also states that, while LSOC will not prevent operational risk (the risk that customer funds are lost as a result of fraud or error), LSOC will enhance the ability to transfer positions after an insolvency resulting from operational failure.[11] The final rules also are intended to address investment risk by establishing a prudential requirement that all investments be "consistent with the objectives of preserving principal and maintaining liquidity."[12]

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4 *Id.*

5 77 Fed. Reg. 6340.

6 77 Fed. Reg. 6339.

7 Any such shortfall in nondefaulting customer funds would not be the result of a customer default because the DCO must use other resources to cover a default. Rather, any such shortfall would be the result of an FCM operational issue as discussed below.

8 77 Fed. Reg. 6338, n. 13.

9 77 Fed. Reg. 6364.

10 *Id.*

11 77 Fed. Reg. 6348, n. 117.

12 77 Fed. Reg. 6348 (describing Rule 22.2(e)(1)). *See also*, CFTC Rule 1.25, which is intended to limit investment risk by restricting how FCMs and DCOs can invest customer funds.

### What will FCMs and DCOs have to do differently for cleared swaps than for futures?

FCMs will be required, at least daily, to submit customer information to DCOs.[13] This information must include the aggregate market value of customer collateral in all cleared swaps customer accounts, the level of margin required for each customer, and the amount of residual financial interest the FCM holds in cleared swaps customer collateral (the difference between the market value of posted collateral and the required margin).[14]

DCOs will be required to calculate and record the collateral required from each cleared swaps customer and the total collateral required for each FCM.[15] The CFTC said that it may consider applying LSOC to futures in a new rulemaking.

### When will DCOs and FCMs be required to implement LSOC?

FCMs and DCOs must implement LSOC for cleared swaps customers by November 8, 2012. The CFTC notes in its release that the November 8 deadline is intended to accommodate the prolonged period that commenters suggested would be required to transition into swaps clearing.[16] In the interim, CFTC rules will not provide for any segregation for cleared swaps collateral, presumably leaving market participants transacting in cleared swaps subject to the Futures Model.[17]

### What does the CFTC identify as the costs and benefits of the LSOC model?

The CFTC acknowledges that the LSOC model has a number of costs and benefits. The CFTC evaluates the costs and benefits of LSOC relative to the futures model in the following categories:

- Reduction of fellow-customer risk;
- “Risk costs” and changes to margin and guaranty fund levels;
- Ability to easily port customer swaps positions;
- Incentives to monitor and control risky FCM behavior;
- Operational costs; and
- Other costs and benefits.

The CFTC reviews these costs and benefits with comparison to the Futures Model.

#### *Why did the CFTC not adopt the Futures Model?*

The CFTC identifies protection against fellow-customer risk as the most significant benefit of LSOC relative to the futures model.[18] Numerous DCOs submitted comments to the CFTC, indicating that LSOC would require them to raise margin requirements, which would result in opportunity costs (reducing the capital available for investments) for market participants. Thus, the CFTC acknowledges that the cost of protecting against fellow-customer risk will include increased costs of higher

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13 Rule 22.2(g).

14 *Id.*

15 Rule 22.12(c).

16 77 Fed. Reg. 6362.

17 *Id.*

18 77 Fed. Reg. 6363.

initial margins and higher fees for swap transactions.[19] The CFTC states it cannot quantify the benefits of LSOC, in part because the two FCM defaults that have occurred in the futures market in the last 20 years are not sufficient "to permit reliable extrapolation" of the benefits of reducing fellow-customer risk.[20]

The CFTC concludes that because LSOC would not permit a DCO to access the collateral of nondefaulting customers, DCOs will be more inclined to allow for easy porting of nondefaulting customer positions away from a failing FCM.[21]

For DCOs, the CFTC identifies an increased cost from LSOC because DCOs would potentially have access to fewer financial resources in the event of an FCM default.[22] The CFTC notes, however, that this cost corresponds to a benefit for cleared swaps customers, which is "consistent with [Dodd-Frank's] goal of protecting customer funds."[23]

### *Why did the CFTC not adopt full physical collateral segregation?*

The CFTC concluded that the Physical Segregation model would achieve roughly the same level of protection as LSOC, but impose greater costs.[24] The Physical Segregation Model would permit a DCO to access the collateral of defaulting FCM customers, but not the property of nondefaulting customers. However, the CFTC states that because Section 766(h) of the Bankruptcy Code requires that customer property be distributed ratably, both defaulting and nondefaulting customers would receive the same percentage distribution in the event of default. As discussed above, such a situation could result from an operational failure by the FCM that causes a loss of customer funds. The CFTC states that because the Physical Segregation Model would achieve "essentially … the same level of protection for its Cleared Swaps Customer Collateral … as it would under the LSOC model," the difference in costs is not justified.[25]

## Will the CFTC permit swap collateral to be held in third-party accounts?

Subject to a number of requirements, in the preamble to the final rules, the CFTC states that customer funds may be held by a third-party custodian. The CFTC in 1984 issued an interpretation that effectively permitted some futures customers to post collateral with a third-party custodian.[26] The policy permitted FCMs to count amounts that customers posted to third-party custodial accounts as part of the FCM's customer segregated funds for accounting purposes so long as the FCM had immediate and unfettered access to the funds held in the account.[27] In 2005, however, the CFTC amended its interpretation to largely prohibit keeping customer funds in a third-party custodial account.[28]

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19 77 Fed. Reg. 6364.

20 *Id.*

21 77 Fed. Reg. 6368.

22 77 Fed. Reg. 6370.

23 *Id.*

24 77 Fed. Reg. 6339.

25 *Id.*

26 Financial and Segregation Interpretation No. 10 on the Treatment of Funds Deposited in Safekeeping Accounts (May 23, 1984).

27 77 Fed. Reg. 6343.

28 *Id.*

In its release, the CFTC states that its original 1984 interpretation will apply to cleared swaps.[29] Accordingly, an FCM *may* permit customers to request that their cleared swaps collateral be held in third-party custodial accounts. Thus, cleared swaps collateral "may be deposited at a bank in a third-party safekeeping account, in lieu of posting such collateral directly to the FCM, without the FCM being deemed in violation of section 4d(f) of the CEA."[30] However, this collateral will remain subject to the Bankruptcy Code and applicable provisions of the CEA and CFTC regulations that have applied to futures, which provide for pro rata distribution of customer property held in a third-party account in the event of a double default.[31]

29 *Id.*

30 *Id.*

31 *Id.*