

CFTC Adopts Final Rule on Protection of Cleared Swap Customer Collateral

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In adopting final rules on the treatment of cleared swap customer collateral, the CFTC has taken a major step in defining the architecture of market-wide swap clearing, a key pillar of the Dodd-Frank Act's derivatives reform. After receiving intense arguments for divergent types of collateral protection, the CFTC adopted the “legal segregation, operational commingling” (“**LSOC**”) model.

The LSOC model is designed to eliminate the “fellow customer risk” to which futures customers are exposed. Under the LSOC model, if a customer of a futures commission merchant (“**FCM**”) defaults on a cleared swap margin obligation and the FCM is not able to satisfy the defaulting customer's obligations, the derivatives clearing organization (“**DCO**”) has no recourse to funds of the FCM's non-defaulting customers. Therefore, LSOC is intended to provide additional protection, albeit at an additional cost, to cleared swap customers beyond the current futures DCO model. In contrast, under the futures DCO model, any FCM customers' swap collateral is available to the DCO upon a default of both the FCM and one of its futures customers. The CFTC has not extended the LSOC model to futures at this time, but will consider doing so.

The rule becomes effective 60 days after publication of the final rule, which is expected shortly. However, DCOs and FCMs are not required to comply with the LSOC model's provisions until November 8, 2012, the date by which compliance with a number of other recently-finalized DCO rules is required.

Customer Swap Clearing

Typical DCO Default Waterfall

Margin of defaulting FCM and customer

- Margin of non-defaulting customer of defaulting FCM may be used here for futures

Guaranty fund contribution of defaulting FCM

DCO capital contribution

Guaranty fund contribution of other clearing member FCMs

Assessments on non-defaulting clearing members

DCOs process, guarantee and settle derivatives transactions. Contracts submitted to clearing are novated by the DCO, resulting in the substitution of the DCO as the buyer to every swap seller and the seller to every swap buyer, largely removing counterparty credit risk between the swap counterparties by transferring it to the DCO. The DCO manages this credit risk in a number of ways. First, the DCO collects initial and daily mark-to-market (variation) margin to buffer itself from a default of either counterparty to the swap. In addition, DCO rules set forth default requirements to address a loss exceeding collected margin. These requirements begin by limiting clearing privileges to clearing members, which must meet high capital and operational standards. Clearing members must also contribute to a “guaranty fund” and are subject to assessments if useable margin, guaranty fund deposits and the DCO's own capital contribution are exhausted. In this way, the residual credit risk faced by the DCO is mutualized among its members.

CFTC's Four Options in the Concept Release

Individually Segregated

Accounts. The cleared swap collateral of each FCM customer is individually segregated at the DCO. The DCO has no recourse to the collateral of a non-defaulting customer of a defaulting FCM.

LSOC / Complete Legal

Segregation. Cleared swap collateral of all of an FCM's customers can be commingled at the DCO. The DCO only has recourse to the collateral of defaulting customers upon a double default of a customer and the FCM.

Complete Legal Segregation

with Recourse. Cleared swap collateral of all of an FCM's customers can be commingled at the DCO. The DCO may only access the collateral of non-defaulting customers of a defaulting FCM at the end of the DCO default waterfall.

Futures Model.

Cleared swap collateral of all of an FCM's customers can be commingled at the DCO. The DCO may access any of the collateral in the commingled account upon double default of a customer of an FCM and the FCM itself.

Because of the high operational requirements and financial obligations associated with DCO membership, most swap counterparties will not become clearing members. Instead, these **clearing customers** will need to develop relationships with clearing members of each DCO at which they wish to clear.

If a clearing customer defaults on a required margin payment to its clearing member FCM, the clearing member FCM remains responsible for providing the margin payment to the DCO. By law, the clearing member FCM cannot use the funds of any other customer for this purpose. If the FCM cannot make the required payment to the DCO, a "double default" occurs. Often, positions of non-defaulting customers can be "ported" from one FCM clearing member to another, keeping those customers from having their positions unwound. DCO rules also specify a "waterfall" of funds that are used to satisfy defaults, generally including margin of the defaulting customer and FCM, the guaranty fund deposits of the defaulting and other FCMs, capital of the DCO itself and assessments on non-defaulting FCMs. The primary issue addressed in the CFTC's final rules is the extent to which, under such circumstances, the margin held at a DCO of non-defaulting swap customers of an FCM involved in a double default can be used by the DCO as part of its waterfall.

The CFTC's Four Options for Treatment of Customer Collateral

The Dodd-Frank Act provisions governing cleared swap collateral differ from, and provide a higher level of protection than, those governing futures margin deposits. The swap provisions bar any person, including DCOs, from treating any funds or property of a swap customer as if it belonged to any person other than the depositing swap customer.¹ This statutory prohibition, coupled with the fact that in many existing swap transactions swap collateral is held by the depositing party's custodian, prompted the CFTC to seek public input on several alternative models for swap collateral protection in addition to the existing futures model. In December 2010, the CFTC issued a concept release describing four potential models and asking for industry input on the costs and benefits of each. The models, described in more detail in the sidebar at left, ranged from the "futures model" of *pro rata* sharing of losses created by a fellow customer's, and subsequent FCM, default to individualized treatment of customers and the resulting

¹ While in the futures context the Commodity Exchange Act prohibits any person that has received customer property from treating it as belonging to "the [FCM] or any person other than *the customers* of such [FCM]," the Dodd-Frank additions to the Commodity Exchange Act for swaps are more restrictive in prohibiting any person that has received customer property from treating it as belonging "to the depositing [FCM] or any person other than *the swaps customer* of the [FCM]." (emphases added).

protection against fellow customer risk. The CFTC held two roundtables on the topic – one before issuance of the concept release, and one after.

In responding to the CFTC's concept release and at the roundtables, market participants generally agreed that, as protection to individual client collateral increases, the operational burden to the FCM and DCO, and therefore cost, will increase. In addition, market participants generally agreed that less recourse to non-defaulting customer collateral would require DCOs to raise margin requirements. However, market participants disagreed vehemently on the size of these effects and the optimal tradeoffs between these concerns. FCMs and DCOs generally argued in favor of the futures model, while potential clearing customers (typically large buy-side firms) generally argued for greater customer collateral protection even with greater associated cost.

In June 2011, the CFTC proposed a rule to implement the LSOC model for cleared swap customer collateral which, as discussed above, limits DCO recourse in the case of a double default to the margin attributable to defaulting customers of the defaulting FCM.²

The Final Rule – “Legal Segregation, Operational Commingling”

On January 11, 2012, the CFTC approved a final rule based on the LSOC model, with only minor changes from its earlier proposal.

Before an FCM Default

The LSOC model carries forward many of the elements of existing futures requirements. FCMs must segregate customer funds, use their own capital to satisfy customer defaults and maintain detailed records of customer positions, margin deposits and accruals and other customer account information. The LSOC model overlays these requirements with additional reporting requirements designed to ensure that the DCO is able, in the event of an FCM default, to accord each customer individualized rather than *pro rata* sharing of losses. The FCM must provide the DCO sufficient information to identify each customer and provide on at least a daily basis information concerning the “portfolio of rights and obligations” attributable to each customer. If the CFTC allows, futures margin may be commingled with cleared swap margin.

² In the proposal, the CFTC renamed the LSOC model the “complete legal segregation” model. For clarity, we use the term LSOC throughout.

Rule 1.25

Rule 1.25 restricts the way in which FCMs and DCOs can invest customer collateral. Subject to rating requirements, concentration limits, liquidation criteria and other risk management requirements, Rule 1.25 allows FCMs and DCOs to invest customer collateral in:

- US government, state and municipal securities;
- GSE securities;
- bank certificates of deposit;
- commercial paper;
- corporate notes or bonds;
- sovereign debt (general obligations); and
- interests in money market mutual funds.

None of these instruments may have embedded derivatives.

FCMs and DCOs may also enter into repurchase agreements on any of the above deposited with them by customers as long as the securities are “readily marketable” and are not “specifically identifiable property” of a customer.

FCMs that are SEC-registered broker-dealers may enter into a limited number of additional types of transactions.

The rule specifies that FCMs and DCOs cannot:

- use the collateral of one cleared swaps customer for the benefit of any other customer;
- use cleared swaps customer collateral for contracts other than cleared swaps of that customer, except pursuant to future CFTC exceptions or DCO rules approved by the CFTC that allow commingling of swaps and futures contracts;
- impose a lien on cleared swaps customer collateral; or
- include as cleared swaps customer collateral money invested in the securities of a DCO, designated contract market, swap execution facility.

The final rule allows FCMs and DCOs to invest customer collateral for cleared swaps in permitted investments under Rule 1.25, which also applies to futures contracts.

Upon an FCM Default

If extreme market events occur, and the FCM is unable to meet margin calls for its customer cleared swaps after a customer defaults to the FCM, a “double default” has occurred. Under such a double default, the DCO will generally attempt to “port” the cleared positions of the FCM’s non-defaulting customers to another clearing member FCM. If it is unable to do so, the DCO may unwind the defaulting FCM’s customer positions. Any losses during this process may be met by the DCO through its default waterfall provisions. However, the final rule does not allow the DCO to use any collateral of the non-defaulting customers of the defaulting FCM. To achieve this, the DCO will need to calculate the margin requirements for each customer of the defaulting FCM using the information provided to it by the FCM. Non-defaulting customers of the defaulting FCM would share *pro rata* in the remaining collateral, a result required by the fact that the Dodd-Frank Act defined cleared swaps as “commodity contracts” under Subtitle IV of Chapter 7 of the Bankruptcy Code.

Other Provisions of the Rule

The final rule also includes a number of additional important provisions related to the cleared swap customer framework. These include:

- **Treatment of Margin Beyond DCO Minimum.** The final rule allows an FCM to post to a DCO margin the FCM requires from its customers beyond the DCO minimum, where it will be afforded LSOC treatment as if it were DCO-required margin.
- **Tri-Party Custody and Interpretation 10-1.** The final rule release indicates that the CFTC will allow collateral for cleared swaps posted from customers to FCMs to be held in a tri-party custody account. In particular, the CFTC indicated that Interpretation 10-1, which was adopted by the CFTC in 2005 and does not permit customer collateral for futures to be held in tri-party custody, does not apply to cleared swaps. Instead, the conditions of the original Interpretation 10, which allowed such arrangements from 1984

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through 2005 for futures, will govern swap collateral held in tri-party custody.

- **Cleared Swap Account Class.** The CFTC also adopted revisions to Part 190 of its regulations in order to extend its cleared swap account class and conform Part 190 to the LSOC rules.

Limitations of the Final Rule and Future CFTC Considerations

A significant portion of the Commissioners' and staff discussion of the rule at the CFTC's open meeting centered upon the disparity between the new LSOC regime for cleared swaps and existing safeguards applicable to futures customer property as well as limitations inherent in the LSOC model itself. Significant points highlighted in this discussion included the following.

- **No Effect on Futures.** The final rule does not change the treatment of customer collateral for futures transactions. CFTC Chairman Gary Gensler indicated at the CFTC's January 11 open meeting that the CFTC would continue to consider whether to apply LSOC to the futures markets and would hold a roundtable on the topic. No such meeting has yet been scheduled.
- **No Additional Restrictions to Limit Operational, Fraud or Investment Risk.** The final rule, by its terms, does not seek to decrease risks to customer collateral arising from operational issues or fraud, risks which have drawn attention in light of the MF Global situation. In addition, as stated above, the rule incorporates the investment restrictions in Rule 1.25, which currently apply to futures. As a result, the final rule does not attempt to decrease the risks inherent to investment of customer collateral in market instruments, known as "investment risk."
- **No Optional Segregated or Third-Party Custodial Accounts at DCOs.** As noted above, while the rule's preamble provides that triparty custody accounts may be used in accordance with the Interpretation 10 conditions, the final rule does not provide customers with the option of individually segregated collateral accounts to hold customer collateral passed to the DCO. Chairman Gensler also indicated that this topic would be raised at an upcoming roundtable.

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