

MEMO# 25865

February 1, 2012

CFTC Adopts Rules for the Protection of Cleared Swaps Customer Collateral

[25865]

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TO: SEC RULES MEMBERS No. 6-12

DERIVATIVES MARKETS ADVISORY COMMITTEE No. 5-12

CLOSED-END INVESTMENT COMPANY MEMBERS No. 5-12 RE: CFTC ADOPTS RULES FOR THE PROTECTION OF CLEARED SWAPS CUSTOMER COLLATERAL

On January 11, 2012, the Commodity Futures Trading Commission ("CFTC") adopted its final rules regarding the protection of cleared swaps customer collateral ("Rules"). [\[1\]](#) After considering several possible alternatives for the protection of cleared swaps customer collateral, [\[2\]](#) the Commission adopted what is known as the "legal segregation with operational commingling" or "LSOC" model. The Rules are summarized briefly below.

Under the LSOC model, each futures commission merchant ("FCM") and derivatives clearing organization ("DCO") is required to segregate on its respective books and records the cleared swaps customer collateral relating to each customer. The entries must specifically indicate that the cleared swaps customer collateral is being held separately from the FCM's or DCO's obligations and from the assets of non-cleared swaps customers.

Pursuant to the final rules the CFTC recently adopted to implement core principles for DCOs, the DCO must collect from the FCM the gross margin required by the DCO for each of the FCM's cleared swaps customers (as opposed to the net margin obligation of all of the FCM's cleared swaps customers in the aggregate). The FCM would continue to hold any margin it requires from its customers over and above the DCO's requirement. [\[3\]](#)

Under the Rules, the FCM and DCO are permitted to hold cleared swaps customer collateral in an omnibus account (an account holding the collateral of multiple swaps customers). An FCM and DCO may not: (i) use the collateral of one cleared swaps customer to benefit another customer; (ii) commingle cleared swaps collateral with other property or collateral, including futures margin, unless future CFTC exceptions or DCO rules approved by the CFTC permit such commingling; (iii) impose a lien on cleared swaps customer collateral; or (iv) include as cleared swaps customer collateral money invested in the securities of a DCO, designated contract market, swap execution facility, or swap data repository. [\[4\]](#) The FCM is required to provide to the DCO information about the identity of each of its customers and the amount of cleared swaps collateral held at the DCO and attributable to such

customer at least once each business day.

The LSOC model differs from the existing futures model for segregation of customer margin (“futures model”) in several ways. Under the futures model, DCOs treat each FCM’s customer account on an omnibus basis, as belonging to an undifferentiated group of customers. DCOs may access any of the collateral in the omnibus account in the event that a customer defaults on its obligations and the FCM is unable to satisfy the defaulting customer’s obligations (“double default”).

In the Release, the CFTC explained that the LSOC model is intended to protect against “fellow customer risk,” or the risk that the collateral of one customer will be used to compensate a DCO for market losses resulting from the swaps of another customer. For example, in the event of a double default, unlike in the futures model, the DCO would have no recourse to funds of the FCM’s non-defaulting customers. When the DCO attempted to unwind the defaulting FCM’s customer positions, it would 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, pursuant to Section 766(h) of the Bankruptcy Code.

The CFTC further explained that the LSOC model also is intended to provide increased portability of customer positions, or the ability of a non-defaulting customer to transfer its positions to another FCM in the event its FCM defaults. Because the Rules require the FCM to provide information about each individual cleared swaps customer’s positions to the DCO at least once per business day, the DCO will have information about each customer’s positions on its own books and records. [\[5\]](#)

The CFTC clarified in the Release that cleared swaps customer collateral may, if the FCM permits and a customer elects to do so, be deposited at a third-party bank in lieu of posting such collateral directly with the FCM. [\[6\]](#) In the event of a default, the collateral would still be deemed “customer property” under the Bankruptcy Code and subject to pro rata distribution. [\[7\]](#)

Under the Rules, parties cannot use collateral margining cleared swaps positions to simultaneously margin positions that are not cleared swaps, such as futures positions. [\[8\]](#) An FCM may, however, realize on a customer’s cleared swaps collateral in the event of a default by the customer under other types of transactions with the FCM.

The Rules will become effective 60 days following publication in the Federal Register. Parties will be required to comply with the Rules by November 8, 2012.

The CFTC has stated that it intends to consider asset segregation issues further, including a proposal to allow individual protection of client assets, and the possibility of adopting the LSOC model for the futures market. The CFTC also has stated that it plans to hold staff roundtables to further consider these issues.

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endnotes

[\[1\]](#) Protection of Cleared Swaps Customer Contracts and Collateral; Conforming

Amendments to the Commodity Broker Bankruptcy Provisions, RIN 3038-AC99, available at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister011112d.pdf> ("Release").

[2] These included: the LSOC model, the legal segregation with recourse model, the physical segregation model, the futures model, and optionality. For more information about the models, please see ICI Memorandum No. 25388 (August 8, 2011), available at http://www.ici.org/my_ici/memorandum/memo25388.

[3] In addition, the FCM may post to a DCO margin the FCM requires from its customers beyond the DCO minimum, and such margin will be treated, under the LSOC model, as if it were DCO-required margin.

[4] Pursuant to Rule 1.25, as recently amended, however, the FCM and DCO may, subject to the limitations in the rule, invest customer collateral for cleared swaps in permitted investments including certain U.S. government securities and U.S. government agency securities, municipal securities, bank certificates of deposit, interests in money market funds, and repurchase agreements and reverse repurchase agreements. See ICI Memorandum No. 25706 (December 13, 2011), available at http://www.ici.org/my_ici/memorandum/memo25706.

[5] In addition, as noted above, the DCO would hold the gross margin required for each customer, rather than the net obligations for all cleared swaps customers of an FCM in the aggregate. Both of these requirements differ from the futures model and should make it easier to port customer positions.

[6] Specifically, the CFTC stated 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 through 2005 for futures, will govern swap collateral held in tri-party custody.

[7] This also would be true under models for the protection of customer collateral the CFTC considered, including at least the LSOC model, the legal segregation with recourse model, and the futures model.

[8] The Rules provide that cleared swaps customer collateral may not be used to "margin, guarantee, or secure trades or contracts" of the cleared swaps customer other than with respect to the customer's cleared swaps positions.