SCHULTE ROTH + ZABEL

NEWS & INSIGHTS

ALERTS

CFTC Publishes Final Rule on Collateral Segregation for Cleared Swaps

March 8, 2012

The Commodity Futures Trading Commission (the "CFTC") issued its final rules requiring futures commission merchants ("FCMs") and derivatives clearing organizations ("DCOs") to segregate collateral posted by customers with respect to cleared swaps (the "Collateral Rules") pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act").[1] The CFTC adopted the legal segregation with operational commingling model (the "LSOC Model"), which (1) requires FCMs and DCOs to segregate cleared swap customers' collateral on their books and records, and prohibits them from commingling customer collateral with their own funds, but permits FCMs and DCOs to commingle customer collateral in accounts with other cleared swap customers; and (2) restricts a DCO's ability to use non-defaulting customers' collateral to cover a defaulting customer's obligations in the event that a cleared swap customer defaults on its obligations to an FCM which, in turn, defaults on its obligations to the DCO (a "double default"), thereby reducing "fellow-customer risk" (i.e., the risk that a DCO would need to access the collateral of non-defaulting customers to cure an FCM default).

Private investment fund managers, and the funds that they manage, should be aware of the Collateral Rules because they impact the fellow-customer, operational and investment risks to their collateral. In addition, the Collateral Rules affect the costs of entering into cleared swap transactions. The effective date of the Collateral Rules will be April 9, 2012. All parties, including private fund managers, must comply with the Collateral Rules by Nov. 8, 2012. While implementation may involve considerable operational changes at DCOs and FCMs, it is not expected that most fund managers will have to make significant changes to their current practices in order to comply with the Collateral Rules.

The LSOC Model differs from the existing model that applies to futures (the "Futures Model"). Under the Futures Model, DCOs treat each FCM's customer account on an omnibus basis without differentiating among customers. In the event of a bankruptcy of an FCM due to a double default under the Futures Model, the DCO would be able to access the collateral of non-defaulting customers and defaulting customers posted to the DCO to satisfy any loss in the customer account.[2]

In the case of a bankruptcy of an FCM due to a double default under the LSOC Model, the most significant benefit to customers of the FCM is their protection (assuming that they are a non-defaulting customer) against fellow-customer risk. Where the shortfall is due to a fellow customer's loss that exceeds both the customer's collateral and the FCM's ability to pay, i.e., a double default, the DCO would be able to access only the collateral attributable to defaulting customers to satisfy the loss and not the collateral of non-defaulting customers.[3] In the event of a double default, the adopted model improves on the current Futures Model by not permitting the DCO to access non-defaulting customer collateral in its default "waterfall" of funds to satisfy any losses created from a defaulting customer. In addition, the adopted model improves on the current Futures Model by requiring customer account data to be transmitted to the DCO daily, thereby providing up-to-date information on which to base account transfers and liquidations, and therefore increasing the portability of non-defaulting customers' positions to other FCMs.

The CFTC has acknowledged the limitations of the Collateral Rules in protecting cleared swap customer collateral due to an FCM's bankruptcy with respect to operational risk or investment risk. Under both the LSOC Model and the Futures Model, if the FCM experiences a bankruptcy as a result of corporate financial difficulties unrelated to customer accounts, there will be no shortfall in the customer accounts and each customer's account can be transferred or liquidated in full by the trustee. However, if the shortfall is due to operational risks such as fraud or mismanagement of customer accounts by the FCM, or investment risks resulting from extraordinary losses on permitted investments, customer positions and related collateral at a DCO may be delivered to the trustee of the bankrupt FCM or may be transferred to a solvent FCM, but only to the extent of each customer's pro rata share.

The CFTC may address operational and investment risks in future rulemakings. The CFTC is also considering whether to modify the Futures Model so that futures customers may benefit from protection against fellow-customer risk available to the cleared swap market customers under the LSOC Model.

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

---

[1] Section 724 of the Dodd-Frank Act amended Section 4d of the Commodity Exchange Act (the "CEA"), imposing on each FCM and DCO the following requirements with respect to collateral posted by customers: (1) the FCM must treat customer collateral as belonging to the customer; (2) the FCM must not commingle any customer's collateral with its own property and generally must not use such collateral to margin any other customer's swaps; (3) the DCO must not treat an FCM customer's collateral as belonging to anyone other than the customer; and (4) the FCM and DCO may invest customer collateral only in certain permitted investments.

[2] In addition to the LSOC Model and the Futures Model, the CFTC considered other models, including the "Physical Segregation Model" and the "Legal Segregation with Recourse Model." The Physical Segregation Model requires that each customer's collateral is segregated in separate physical accounts as well as in the FCM's books and records. The Physical Segregation Model is similar to the LSOC Model after an FCM bankruptcy. However, it would be much more expensive to implement this model. In other words, in spite of incurring greater costs, the level of protection for cleared swaps customers would be essentially the same for fellow-customer risks, investment risks, and operational risks. Therefore, the CFTC did not select this model. The Legal Segregation with Recourse Model is similar to the adopted model prior to a default, but after a double default, the DCO would be able to access the collateral of non-defaulting customers if the DCO's own capital and FCM guaranty funds were insufficient. The CFTC also considered allowing each DCO to choose one

of the foregoing models rather than mandating any particular one. The CFTC ultimately adopted the LSOC Model because it determined that the model strikes the best balance between costs and risks.

[3] To the extent that the defaulting customers' collateral does not satisfy the loss, the DCO must use its default resources in an order pre-determined by the DCO's rules. The default resources may include guaranty fund contributions, the DCO's own capital, and the DCO's right to call upon its members to contribute additional assets.

Related People

Craig Stein

Partner

New York

Practices

BUSINESS REORGANIZATION

DISTRESSED DEBT AND CLAIMS TRADING

FINANCE

REGULATORY AND COMPLIANCE

STRUCTURED FINANCE

Attachments

Download Alert