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CFTC Adopts "LSOC" Model for Protection of Cleared Swaps Customers' Margin, Marking a Significant Departure From the Traditional U.S. Futures Model

Key Takeaway: CFTC adopts LSOC for cleared swaps with conforming amendments to the FCM (Part 190) insolvency rules. LSOC reduces but does not eliminate the "fellow customer risk" that exists in the futures model. LSOC also does not address investment risk or operational risk and thus does not solve the MF Global problem. LSOC may increase swap clearing costs due to higher margin, guaranty fund and assessment requirements imposed by DCOs stripped of access to non-defaulting swap customers' margin. The CFTC is to consider harmonizing both regimes and whether to adopt additional protections.

Background

What is this "LSOC" thing I keep hearing about?

As discussed in more detail below, "legal segregation with operational commingling" or "**LSOC**" is the new segregation regime adopted by the Commodity Futures Trading Commission (the "**CFTC**") for the protection of cleared swaps customers' margin. In the traditional U.S. futures model, a customer default that causes a futures commission merchant (an "**FCM**") default (a "**Double Default**") exposes non-defaulting customers of that FCM in the same customer account class as the defaulting customer to a pro rata portion of any deficiency in that account class. This risk is referred to as "fellow customer risk" and was of significant concern to many buyside market participants anticipating being subject to mandatory swap clearing and currently requiring full third-party margin segregation in the bilateral context.

Why is it important and who cares about it?

With the adoption of LSOC, in a Double Default scenario, non-defaulting swap customers' margin is no longer available to satisfy a deficiency caused by another customer of the defaulting FCM. Instead such a deficiency will have to be satisfied from other elements of the derivatives clearing organization's ("**DCO**") available financial resources, including property of the defaulting FCM and the defaulting customer. This is significant for any market participant that intends to clear indirectly through an unaffiliated FCM because it makes doing so somewhat less risky. It is also significant for DCOs, FCMs and anyone that intends to clear

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directly as it will likely result in changes to margining requirements as well as increased funded and unfunded obligations of FCMs to DCOs.

Adoption of the LSOC Model

The CFTC adopted final rules (the "**Final Rules**") on January 11, 2012 that will govern the protection of the swaps contracts and related collateral of cleared swaps customers by FCMs and DCOs.[1] The rulemaking adds a new Part 22 to the CFTC's regulations on the segregation of customer property (the "**Part 22 Regulations**"), and makes conforming and technical amendments to its Part 190 regulations on FCM bankruptcies (the "**Part 190 Regulations**"). In the Final Rules, the CFTC rejected a number of potential alternative segregation regimes, including that currently employed in the futures model, and instead opted for the LSOC model for the cleared swaps market. The Final Rules implement Section 724 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[2]

The LSOC Model

How does the LSOC model work?

Under the LSOC model, FCMs must segregate swap customers' property from their own property, and DCOs are required to segregate swap customer property from both their own property and the property of a customer's FCM. Both DCOs and FCMs must treat each swap customer's property as belonging solely to the customer. The assets of all of an FCM's swaps customers may be operationally commingled in one account at each of the FCM and DCO levels, though the FCM and DCO must maintain books and records identifying the property of individual customers. Under the Final Rules, FCMs are required to prevent DCOs from using, and DCOs are prohibited from using, a swap customer's property as collateral for another swap customer's swap contracts.

The Final Rules restrict a DCO's uses of a swap customer's collateral and prohibit an FCM from granting a lien against a customer account. The CFTC explained, however, that a customer may grant a lien on its account, and that permitting a customer to do so would not run afoul of the prohibition on an FCM's granting of a lien, thus permitting certain netting and financing arrangements. The CFTC also clarified that variation margin posted by a swap customer could be "passed through" by a DCO and used to post variation margin for offsetting swaps. The CFTC refused to take a position on whether posting of variation margin in respect of cleared swaps should be treated as settlement for tax purposes.

The Final Rules also require FCMs to compile and transmit to DCOs information about swap customer portfolios on a daily basis. The regulations will require an

[1] Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions, *available at* http://www.cftc.gov/PressRoom/Events/ssLINK/federalregister011112d.

[2] Pub. L. No. 11-201, 124 Stat. 1276 (2010).

FCM to provide a DCO with information "sufficient to identify . . . the portfolio of rights and obligations" that the FCM intermediates for a customer. The CFTC noted that DCOs may require more frequent updating from FCMs.

How does LSOC differ from the traditional futures model?

The LSOC Model differs from the traditional futures approach and the other models considered by the CFTC in how it handles Double Defaults. Such Double Defaults might occur when a cleared swaps customer experiences a catastrophic loss on one or more cleared swap positions, the DCO that cleared the swap(s) demands a large payment or the posting of significant additional variation margin, the FCM's customer is unable meet such demand, and the deficiency is so large that it forces the FCM to default and declare insolvency, leaving a deficiency in the relevant customer account class (i.e. less assets available than are needed to satisfy all claims). Under the LSOC model, a DCO facing a Double Default cannot apply the property of non-defaulting swap customers of the defaulting FCM to satisfy such a deficiency, but rather must look only to the property of the defaulting customer and other available financial resources (e.g., assets of the defaulting FCM, its own equity, the guaranty fund or unfunded assessments). Conversely, under the current futures model, if a Double Default were to occur, the DCO would have recourse to the property of any customers of the FCM in the same account class, including non-defaulting customers.[3]

How does LSOC work in an FCM insolvency?

The LSOC model will also handle an FCM's bankruptcy differently than other models. Unlike the segregation model currently used in the futures model, under the LSOC model, DCOs would receive information about swap customers' portfolios on a daily basis, which they could use to facilitate swap customer position transfers to other FCMs upon an FCM insolvency. If an FCM's bankruptcy results from a Double Default, the LSOC model would protect non-defaulting swap customers' property by making it unavailable to the DCO, which will facilitate porting the non-defaulting swap customers' positions to another FCM. While portfolios are portable under the futures model, because a DCO has recourse to the collateral of all of a defaulting FCM's futures customers, any deficiency can significantly hamper porting.

Risks Addressed (and Not Addressed) by the Final Rules

By the CFTC's own admission, the Final Rules directly address only fellow customer risk. The regulations do not, however, reduce "investment risk" – the risk that an FCM faces a shortfall because of its investment of customer collateral. Nor do they address the "operational risk" that an FCM improperly segregates customer property and faces a shortfall because of negligence, theft or other malfeasance. As noted by CFTC Commissioner O'Malia, the Final Rules

[3] It is worth noting, however, that due to the nature of the segregation regime and the overcollateralization inherent in initial margin requirements, it is exceedingly unlikely that a Double-Default would ever actually occur.

would not have prevented the "MF Global problem" that an FCM illicitly uses customer property to take proprietary positions, only to face insurmountable losses on those positions leading to its bankruptcy. In that event, swap customers in the same account class would share in the shortfall on a pro rata basis, and they would not be able to quickly transfer their portfolios to another FCM.

The LSOC model does no more to protect customer property held by an FCM than does the futures market segregation model. Under both models, an FCM must segregate its own property from its customers', and must treat customer property as such. However, customers under the LSOC Model are just as exposed to operational and investment risk at the FCM level as futures customers are. The Final Rules allow an FCM to deposit its own funds with a DCO, which may then be used to margin the swaps of any customer. They also, however, allow an FCM to move to a DCO any collateral posted by a customer in excess of the required amount if the DCO's rules allow it.

The Future of Futures and the LSOC Model

During its hearing and throughout the rule release, the CFTC indicated that it was still in the process of considering additional protections for customer property, though it noted that some possibilities would impose additional costs on market participants.[4] It is likely, if not virtually certain, that the Final Rules are not the CFTC's last word on the subject. The CFTC has taken the following actions that indicate possibilities for future regulation:

> The CFTC has directed its staff to analyze proposed alternatives to the LSOC model "that would provide individual protection" for customer property.[5]

> The CFTC is considering whether to adopt the LSOC model for the futures market.

> The CFTC is evaluating a commenter's proposal of mandating additional disclosure requirements to enhance customer collateral protection.

> The CFTC stated that, while the Final Rules only require DCOs to obtain customer portfolio information daily, it would consider mandating more frequent collection if such became an industry standard.

[4] The CFTC's rule release contained a fairly robust cost-benefit analysis, at least when compared to the analysis provided with respect to some earlier CFTC final rules. This is likely a product of the lawsuit brought to nullify the CFTC's position limits rule, in which SIFMA and ISDA allege that the CFTC did not engage in a sufficient cost-benefit analysis.

[5] In his opening statement, Commissioner O'Malia opined that the Final Rules may actually provide less protection to swaps customers than is currently available in the over-the-counter market, noting that current customers have the option of using a tri-party custody arrangement to protect their collateral.

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Compliance Dates

FCMs and DCOs are not required to comply with the Part 22 Regulations until November 8, 2012. Compliance with the Part 190 Regulations commences 60 days after publication of the Final Rules in the Federal Register. Between that date and November 8, 2012, the Final Rules would not technically require segregation of cleared swaps or related collateral, and the relevant protections under the Part 190 Regulations would be limited to cleared swaps and related collateral that are subject to segregation under the rules of a DCO as is the case currently.

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