

CFTC Adopts Final Rules Regarding Protection of Cleared Swaps Collateral

On January 11, 2012, the Commodity Futures Trading Commission (CFTC) adopted its final rules regarding the protection of cleared swaps collateral under the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Dodd-Frank Act). These rules impose requirements on futures commission merchants (FCMs) and derivatives clearing organizations (DCOs) regarding the treatment of cleared swaps collateral, and make certain conforming amendments to bankruptcy provisions applicable to commodity brokers under the *Commodity Exchange Act*. The final rules have many similarities to the existing rules regarding the treatment of futures collateral, but include several additional customer protections.

The CFTC adopted what is known as the “legal segregation with operational commingling” or “LSOC” model for segregation of cleared swaps customer collateral. Under the LSOC model, both the FCM and the DCO are required to segregate on their respective books and records the cleared swaps collateral relating to each customer. The entries must indicate that the cleared swaps customer collateral is being held separate from the FCM’s or DCO’s obligations, as well as from the assets of non-cleared swaps customers. The FCM will be required to post to the DCO the gross margin required by the DCO of each of the FCM’s cleared swaps customers, rather than just 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 customer over and above the DCO’s requirement.

Each of the FCM and DCO are permitted to hold cleared swaps customer collateral in an omnibus account (an account with the collateral of multiple swaps customers), but may not commingle cleared swaps collateral with other property or collateral (including, for example, futures margin). Unlike in the existing futures model for segregation of customer margin, the FCM also will be 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 offers two key advantages over the existing futures model for segregation of collateral in the event of an FCM default:

- **Additional protection against fellow customer risk**: Following a default by a cleared swaps customer and its FCM (a “double default”), the DCO would be able to access collateral of defaulting cleared swaps customers, but not the collateral of any non-defaulting cleared swaps customers, to satisfy the DCO’s payment obligations to other market participants arising from the default. Under the existing futures model, in a double default scenario, the DCO would generally be permitted to access collateral of any customers of an FCM to cure the default, a risk commonly known as “fellow customer risk.”
- **Increased portability**: Because the FCM will be required to provide information about each individual cleared swaps customer’s positions to the DCO at least once per business day (but may do so more frequently) – which FCMs are not required to do under the existing futures model – the DCO will have information about each customer’s positions on its own books and records. Also, the DCO will hold the gross margin requirement of each customer, rather than just the net obligation of all customers of an FCM. In an FCM default scenario, this arrangement is likely to make it easier for the DCO to facilitate transfers of customer positions to another FCM than under the futures model.

Other items of note in the final rules include the following:

Use of Third-Party Custodial Accounts: The CFTC clarified in the adopting release for the final rules that cleared swaps customer collateral may, at the customer's option, be deposited at a third-party bank in lieu of posting such collateral directly with the FCM. Use of a third-party custodial account will likely provide only limited additional protection to cleared swaps customers, however, because the cleared swaps collateral – even if it is held in a segregated account with a third-party custodian – will be deemed “customer property” under the Bankruptcy Code in the event of an FCM insolvency, and so would be available to satisfy customer claims generally in the event of a default by an FCM. However, a customer would have a right to have its claim satisfied by assets in the tri-party account up to the amount of the customer's pro rata claim against the customer property held by the defaulting FCM.

Limitations on Investment of Customer Collateral: The rules allow FCMs to invest cleared swaps customer collateral in accordance with CFTC Regulation 1.25, which was amended in the wake of the MF Global insolvency. As of February 17, 2012, when the amendments take effect, FCMs may generally invest customer collateral in 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. Regulation 1.25 similarly applies to an FCM's investment of futures collateral.

Limitations on Cross-Collateralization of Customer Positions: 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. Thus, parties will not be able to use collateral margining cleared swaps positions to simultaneously margin positions that are not cleared swaps, such as futures positions. However, the rules do not prohibit an FCM from realizing on a customer's cleared swaps collateral in the event of a default by the customer under other types of transactions with the FCM.

Registered Investment Company Considerations: Although Section 17(f) of the *Investment Company Act of 1940* requires a registered investment company's assets to be held with a custodian meeting certain qualifications, Rule 17f-6 permits registered investment companies to post futures collateral to an FCM, subject to certain conditions. In connection with over-the-counter derivatives transactions, registered funds generally hold collateral at their custodians through a tri-party arrangement. At this time it is unclear whether registered funds will be required to hold cleared swaps collateral in a tri-party arrangement, or whether the Securities and Exchange Commission will take formal action, such as by amending Rule 17f-6, to permit registered funds to post cleared swaps collateral to an FCM.

Compliance Dates

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

The text of the final rule release is available [here](#).

Please contact the Ropes & Gray attorney who usually advises you with any questions.