November 30, 2010

Protecting Customer Margin for Cleared and Uncleared Swaps

The Commodity Futures Trading Commission (CFTC) continues to issue regulations implementing the OTC derivatives provisions of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Dodd-Frank Act). The CFTC recently released an advanced notice of proposed rulemaking and a proposed rule that together address safeguarding customer margin for swaps, both cleared and uncleared.

Clients active in OTC derivatives markets will want to follow these rules closely, because they will directly affect the protection of their margin for cleared and uncleared derivatives, as well as the costs that will be incurred entering into derivatives under the new legislation.

CFTC Seeks Buy-Side Input on Segregation of Customer Margin for Cleared Swaps

By releasing the advanced notice, the CFTC has signaled its desire for more information about a critical industry issue: the protection of customer margin for cleared swaps. The CFTC's first effort to study this issue was a CFTC Staff Roundtable held on October 22, 2010 (transcript available here). This roundtable revealed a divide on this issue between the derivatives clearing organizations (DCOs) and futures commission merchants (FCMs) on the one hand and non-dealer OTC swap market participants on the other. DCOs and FCMs have built margin systems based on the futures model that allows customer margin to be commingled in an omnibus account. Once a defaulting customer's margin has been exhausted and the FCM has failed to make the clearinghouse whole, margin of other customers of the FCM may be used to meet the FCM's obligations to the clearinghouse. Margin of non-defaulting customers held in such omnibus account therefore insulates non-defaulting FCMs and the DCO from the failure of an FCM resulting from a customer default (what the CFTC has termed "fellow-customer risk"). By contrast, buy-side customers want at least the option to choose a segregated account for margin, to protect their margin from this fellow-customer risk.

In the advanced notice, the CFTC requests comments on four models that offer different degrees of protection for customer margin against fellow-customer risk:

1) The current futures model, as described above.

2) A model that is similar to the current futures model, except that before any non-defaulting customer's margin is used to cover a fellow-customer loss, the DCO must first apply to the loss the contributions to the DCO's guaranty fund by the DCO and the non-defaulting FCMs. The CFTC says that, under this model, a customer will be subject to fellow-customer risk only in the most extreme of circumstances (when a default has consumed the entire guaranty fund of the DCO).

3) A model under which margin of multiple customers could be commingled in an omnibus account, but the collateral in the account would be attributed to individual clients based on the collateral requirements for such customer's swaps.

> Under this model, in general, following a loss from a fellow-customer risk, each non-defaulting customer should receive from the omnibus account the value of collateral attributed to that customer (or have such amounts transferred to another FCM). However, that amount will not necessarily be the same as the amount of margin previously posted by the customer to the FCM. The FCM will be able to post the aggregate amount of customer margin required of the FCM by the DCO on an omnibus basis, and if the value of that margin declines due to market fluctuations in the value of the collateral (for example, due to investment of the collateral by the FCM in accordance with CFTC rules), the margin attributed to each customer would be reduced on a pro rata basis. As a result, margin of a non-defaulting customer could be at risk to the extent of its pro rata portion of the decline in market value of the margin of fellow customers in an FCM's omnibus account.
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> 4) A model requiring individual segregation of each customer's collateral at all levels (at the FCM, DCO, and at each custodian).
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> This model should insulate non-defaulting customers from fellow-customer risk. This approach is similar to the approach some parties agree to under the ISDA Credit Support Annex (CSA), the OTC swap industry standard collateral agreement, where initial margin (independent amount) is held in a segregated tri-party account at a custodian and pledged to the counterparty.

The first important question about these alternatives is posed by the CFTC in the advanced notice: should one of the models be mandatory or alternatively should FCM customers have the option to choose a segregated account? Based on the success of collateral management in the OTC market under the ISDA CSA, giving FCM customers a choice of models might appear to be the better alternative, notwithstanding that different collateral options could entail different costs. The CFTC may, however, be concerned ultimately that different customers having different collateral management arrangements could complicate matters in the event of a default by a customer of an FCM -- and if some customers have elected segregation, that would of course increase the fellow-customer risk of customers who have not elected segregation and who would need to assume a greater percentage of a fellow-customer loss.

A second important question is who will bear the costs associated with the various models. The CFTC notes in the advanced notice that it is attempting to achieve two goals: protection of collateral and minimizing costs. It says that one clearinghouse estimated that segregation would cause an increase in required collateral of about 60% over margin required under the futures model. In the advanced notice, the CFTC directly asks DCOs and FCMs to supply data supporting assertions that alternative models to the futures model would increase costs that would need to be passed on to customers. The CFTC also asks FCM customers to comment on the benefits and costs of each model.

The CFTC also asks buy-side and end-user swap market participants whether they should play an expanded role in monitoring FCMs to reduce their fellow-customer risk and, if so, what additional information about the FCM and other FCM customers would be needed to take on this responsibility. The consensus at the CFTC Roundtable regarding this question was that a DCO was in a better position to monitor FCM risk than FCM customers.

An interesting aspect of the advanced notice is its assumption that initial margin and variation margin will not be treated differently under any model. By contrast, in a March 1, 2010 joint paper discussing independent amounts under the ISDA CSA in the OTC derivatives markets, the Managed Funds Association (MFA),

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ISDA, and the Securities Industry and Financial Markets Association (SIFMA) recommended that variation margin should not be subject to any segregation restrictions.

The willingness expressed by both the CFTC staff and commissioners to hear from industry participants presents a short-lived opportunity, as the deadline for comments is 45 days after publication of the CFTC advanced notice in the Federal Register, which is expected shortly. The CFTC plans to issue a proposed rule soon after the comment period for the advanced notice closes.

CFTC Details Customer Right to Place Initial Margin for Uncleared Swaps in Tri-Party Segregated Account

Under the Dodd-Frank Act, a swap dealer or major swap participant (MSP) must notify each counterparty to an uncleared swap that the counterparty has a right to require initial margin posted by the counterparty be segregated at a third party custodian in accordance with CFTC rules.

Under the CFTC proposed rule implementing this provision of the Dodd-Frank Act, a swap dealer or MSP is required to send a notification of a customer's right to segregate initial margin before a swap is confirmed (and thereafter not less than once in any calendar year) and ask the customer to elect or decline segregation of initial margin. Any election made in connection with such notification would cover all uncleared swaps entered between the parties after that time until the election is changed in a written notice to the swap dealer or MSP. The proposed rule requires the notification be made to a chief risk officer, or if there is no such officer, the chief executive officer or the highest-level decision-maker for the counterparty, and that the swap dealer or MSP obtain confirmation of receipt. In the supplementary information for the proposed rule, the CFTC asks if it should require swap dealers or MSPs to disclose the costs of segregation in the notification, whether in the form of custodial fees or price adjustments offered to the customer for renouncing or electing segregation. The CFTC has not indicated that there will be limitations on the costs imposed, directly or indirectly, by swap dealers and MSPs for segregated accounts, which may limit their use.

If a customer elects segregation of initial margin for its uncleared swaps, the CFTC proposed rule requires that the margin be segregated with a custodian "independent" of the swap dealer or MSP and customer and held in a segregated account designated as such and for and on behalf of the customer. The choice of the custodian is left to the parties. The proposed rule allows an affiliate of a swap dealer, MSP or customer to serve as a custodian of initial margin for an uncleared swap to which the affiliate custodian itself was not a party. In its release, the CFTC says that the reason the proposed rule permits affiliates to serve as custodians is to allow parties to engage in swaps with affiliates of their typical custodians. However, this may increase pressure from swap dealers for segregated accounts to be held at their affiliated custodians, rather than at third party entities.

The proposed rule further requires that any segregation agreement be in writing and that the custodian be a party to the agreement. The written agreement must provide that the custodian will release margin from the segregated account in one of only two ways: either pursuant to agreement of the swap dealer or MSP and customer or upon the custodian's receipt of a written request, made under oath or under penalty of perjury under 28 U.S.C § 1746, that the party seeking the release is entitled to such release pursuant to an agreement between the parties, with a notice about the release immediately sent to the other party following such release. The proposed rule does not include any requirements as to when the agreement between the parties to the swap must allow (or may not allow) release of assets from the account; for example, there is no

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requirement that a counterparty be able to obtain release of assets from the account in the event of a swap dealer's default.

The proposed rule does not govern what collateral is eligible to be posted as initial margin but does direct that the initial margin in the segregated account be invested consistent with the standard for investment of funds that applies to futures margin. The proposed rule leaves the parties free to allocate gains and losses resulting from investment of initial margin. The proposed rule states that the account may also hold variation margin.

If a customer elects not to segregate initial margin for its uncleared trades, the CFTC proposed rule requires the swap dealer or MSP to report to the customer on a quarterly basis "that the back office procedures of the swap dealer or major swap participant are in compliance with the agreement of the counterparties." While this language is consistent with similar language in the Dodd-Frank Act, it is unclear what benefit this requirement would provide to the swap dealer's or MSP's counterparties.

CFTC Clarifies Treatment of Portfolio Margining Account in FCM Bankruptcy

The CFTC has also proposed rules clarifying that securities held in a portfolio margining account carried as a futures account are customer property and that the owners of those accounts are customers for purposes of the bankruptcy law applicable to FCMs.

The deadline for comments on these proposed rules and the proposed rule segregating customer initial margin for uncleared swaps is 60 days after publication of the CFTC proposed rules in the Federal Register, which is expected shortly. Final rules are expected before July 15, 2011, the effective date for the derivatives provisions of the Dodd-Frank Act.

If you have questions about the advanced notice, the proposed rule or their impact on your business, please contact Ropes & Gray Derivatives Practice co-heads Tim Diggins and Leigh Fraser, Deborah Monson, or your usual contact at the firm.

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