Commodity Futures Trading Commission
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Q & A – Final Rule on the Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions

What does the rulemaking do?

This rulemaking sets forth the rules and procedures for protecting collateral posted by cleared swaps customers. Specifically, it implements Section 724 of the Dodd-Frank Act, which prescribes the manner in which cleared swaps (and related collateral) must be treated prior to and after bankruptcy. Section 724(a) amended the CEA by inserting a new section 4d(f), which requires each futures commission merchant ("FCM") and derivatives clearing organization ("DCO") to (i) hold cleared swaps customer collateral in an account (or location) that is separate from the property belonging to the FCM or DCO, and (ii) not use the collateral of one cleared swaps customer to (A) cover the obligations of another cleared swaps customer or (B) the obligations of the FCM.

Section 724(b) governed the bankruptcy treatment of cleared swaps (and associated collateral) by clarifying that cleared swaps are "commodity contracts" within the meaning of section 761(4)(F) of the Bankruptcy Code, and that associated collateral, when deposited by cleared swaps customers, would be subject to the protections of Subchapter IV of Chapter 7 of the Bankruptcy Code and Commission Regulation Part 190 (*Bankruptcy Rules*).

Many regulations are adopted largely as proposed, although a number of provisions have been revised in light of the comments received. The regulations are designed to strike an appropriate balance between the benefits of enhancing protections for cleared swaps customer collateral and promoting portability, and the costs of such changes.

Who must comply with the final regulations?

The regulations apply to all FCMs and DCOs registered with the Commission that clears swaps.

What model is the Commission adopting?

After careful considering of all comments received by the commission through external meetings, filings and roundtables, the Commission is adopting a model entitled "Complete Legal Segregation" (also known as the "LSOC Model"). This model allows the collateral of all of an FCM's cleared swaps customers to be kept together ("commingled") pre-bankruptcy and requires information about the FCM's cleared swaps customers' portfolios to be sent to the applicable clearing organization(s) at least once a day. But, in the event of a default by both a clearing member FCM and one or more of the clearing member's cleared swaps customers, a DCO would not have recourse to the collateral posted by non-defaulting cleared swaps customers. The DCO would only have recourse against the collateral of the defaulting cleared swaps customers of that clearing member (as well as resources of the clearing member itself).

Under the Complete Legal Segregation Model must an FCM's cleared swaps customer accounts be segregated pre-bankruptcy?

The Complete Legal Segregation Model requires that cleared swaps customer collateral be segregated from the FCM's own property, but permits the cleared swaps collateral of all of the FCM's cleared swaps customers to be kept together pre-bankruptcy. The rules, to the extent applicable, parallel (in updated language) the regulations governing the segregated accounts in which FCMs currently hold futures customer collateral pre-bankruptcy.

How does the Complete Legal Segregation Model protect an FCM's cleared swaps customer collateral following a bankruptcy of the FCM?

Following an FCM's bankruptcy, where there is a shortfall in the cleared swaps customer account due to a cleared swaps customer loss that exceeds both the customer's collateral and the FCM's ability to pay, the DCO could only use the collateral attributable to the cleared swaps customers whose portfolios of positions at the DCO suffered losses to meet the loss. Thus, all collateral attributable to cleared swaps customers whose portfolios of positions gained or were "flat" (neither gained nor lost), and the remaining collateral attributable to cleared swaps customers whose portfolios of positions lost, would be immediately available for transfer. Moreover, the DCO would have information that is no more than one business day old tying cleared swaps customers to portfolios of positions, and the DCO itself would maintain the margining methodology that would tie such portfolios of positions to the collateral requirement associated with such portfolios. Even if the DCO decided to liquidate all cleared swaps customer positions, non-defaulting cleared swaps customers would be exposed to less loss. However, if following an FCM's bankruptcy there is a shortfall in the cleared swaps customer account due to an operational issue (for example, there is a shortfall due to negligence, theft or some other mishap), cleared swaps customer positions and related collateral at a DCO may be delivered to the Trustee, or may transferred by the DCO, but only to the extent of each customer's pro rata share.

What types of investments does the Commission permit for cleared swaps customer collateral?

The rules provide that cleared swaps customer collateral may only be invested pursuant to Commission Regulation1.25 (as it may be amended from time to time), which governs the investment of customer property of futures customers. The regulations do not, however, limit the types of collateral that a cleared swaps customer may post, though such customer must comply with the rules of its FCM and DCO.

What other matters do the rules address?

The Commission amended Regulation Part 190 to implement changes wrought by the Dodd-Frank Act, including the inclusion of swaps cleared with a DCO as customer contracts for all commodity brokers, the inclusion of swaps execution facilities as a category of trading venue, and to implement additional statutory changes to time periods. The rules also include changes to conform Regulation Part 190 to current swaps market practices.