

PLI Advanced Swaps & Other Derivatives 2016 Clearing Panel

Customer Funds Segregation for Cleared Derivatives Under the CEA Framework

Kathryn M. Trkla, Partner

312-832-5179

ktrkla@foley.com



Who is Subject to Segregation Requirements Under the CEA Framework?



- Customer funds associated with cleared derivatives are protected by segregation requirements imposed under the Commodity Exchange Act (“**CEA**”) and various rules of the Commodity Futures Trading Commission (“**CFTC**”).
- The segregation requirements apply to:
 - Futures brokers, called futures commission merchants (“**FCMs**”);
 - Clearing houses registered with the CFTC as derivatives clearing organizations (“**DCOs**”); and
 - Third parties receiving protected segregated funds from an FCM or DCO, including banks or trust companies they use to hold customer segregated funds.

Segregation by Category of Derivative/“Account Class”



- The CFTC has different segregation rules for different categories of cleared derivatives:
 - Futures and options on futures listed on a U.S. futures exchange (collectively, “*futures*”);
 - Futures and options on futures listed on a foreign board of trade (collectively, “*foreign futures*”); and
 - Cleared swaps.
- An FCM must maintain, as relevant for the types of derivatives it clears, separate futures, foreign futures and/or cleared swaps accounts for its customers.
- Customers in a particular “account class,” e.g., the futures account class, have a claim against the corresponding segregated pool of funds in the event its FCM is the subject of a “commodity broker” bankruptcy liquidation proceeding under the U.S. Bankruptcy Code and the CFTC Part 190 Rules.

Who is Protected by Segregation: Customer Accounts vs. Proprietary Accounts

- An FCM may clear trades for affiliates or other insiders, but they are considered “non-public” customers of the FCM and their accounts are classified as “proprietary accounts” of the FCM.
- Segregation requirements protect funds of “public” customers of an FCM, i.e., customers whose accounts are not classified as proprietary.
- In the event of an FCM’s bankruptcy, claims of public customers in a particular account class have priority over claims of non-public customers against the relevant pool of segregated funds.
- If there is a shortfall in a particular pool of segregated funds, the loss is shared pro rata by the public customers in the corresponding account class. (Non-public customers will not receive any distributions.)

What are Customer Funds?



- Customer funds protected under the segregation requirements include:
 - Cash, securities or other property deposited in the customer’s account with its FCM to guarantee, margin or secure the customer’s cleared positions; and
 - Accruals on the customer’s cleared positions (e.g., daily mark-to-market gains).
- FCMs and DCOs are permitted to invest customer funds (subject to restrictions), and any such investments are also treated as segregated customer funds.
- FCMs are also required to deposit their own funds into segregation to meet “target residual interest” requirements and, once deposited, such funds are deemed customer funds.

Some Basic Segregation Concepts



- Customer funds belong to the customers.
- An FCM may not use the funds of one customer to meet the obligations of another customer or of any other person.
- At a minimum, an FCM must hold sufficient funds in segregation to meet its obligations to its customers, in an amount at least equal to the aggregate amount represented by customer accounts with positive account balances.
 - FCMs are required to deposit and maintain their own funds in segregation to maintain a cushion of “excess” funds, in accordance with residual target interest policies they are required to adopt.
 - Such funds are treated as segregated customer funds, in which the FCM has a secondary, or residual, interest.
 - FCMs are subject to restrictions on withdrawing excess funds from segregation for their own use.
- An FCM is not permitted to commingle customer funds with its own funds outside of segregation.

Some Basic Segregation Concepts



- Segregation applies to an FCM both with respect to:
 - Recording customer positions and funds in internal bookkeeping accounts.
 - Separate accounts for each customer (may include customer omnibus accounts for other FCMs or foreign brokers).
 - Reflected in account statements issued to customers.
 - How it deposits (holds) customer funds with a bank or trust company or other permissible custodian.
 - Funds of multiple customers within an account class may be commingled, but in accounts clearly designated as segregated accounts holding protected funds belonging to the FCM's customers.
 - Custodian must sign and provide the CFTC with an acknowledgement letter.

Some Basic Segregation Concepts




- A pool of segregated funds may be comprised of customer funds “held” by the FCM in multiple locations:
 - Funds deposited with another FCM to margin customer positions cleared through such other FCM;
 - Funds deposited with a DCO to margin customer positions cleared through the DCO;
 - Funds deposited with a foreign broker or a foreign clearing house to margin customer foreign futures positions cleared through such person.
 - Funds it directly maintains in an account with a bank or trust company as custodian (basically, funds it has not redeposited with another FCM, a DCO or a foreign broker or foreign clearing house).


Segregation at the DCO Level: Futures vs. Cleared Swaps

- The DCO will maintain, as internal accounts, separate customer and house accounts for a clearing FCM.
 - Customer Account Structure for Futures: Omnibus account carrying commingled positions and margin funds of multiple customers of the FCM.
 - “LSOC” Customer Account Structure for Cleared Swaps: Separate accounts/sub-accounts for each underlying cleared swaps customer of the FCM.
- At the custodian level, funds of multiple customers are commingled (separately by account class) in the segregated accounts that the DCO maintains with its custodians.
- The DCO may only use funds in the clearing FCM’s customer account to meet obligations for that account; it may not use them to meet the FCM’s obligations in the house account or to meet the obligations of any other person.
- The LSOC structure for cleared swaps is intended to eliminate the risk – which exists with respect to futures – that the DCO could use funds of one customer of an FCM clearing member to meet the obligations of another customer of the FCM.

Related Protections

- 
- FCM daily segregation calculations.
 - FCM capital requirements.
 - FCM reporting of segregation or capital violations to the CFTC and its designated self-regulatory organization.
 - FCMs and DCOs are subject to restrictions on where they may hold segregated customer funds.
 - FCMs must have risk programs and targeted residual interest policies, and are required to “top up” to cover under-margined customer accounts.
 - FCMs and DCOs are subject to restrictions on investing segregated funds.
 - Subject to strict CFTC limitations on permissible investments.
 - Must hold the investments as customer segregated property.
 - May not allocate investment losses to the customer or to clearing members.

Acronyms




CP	Counterparty
CCP	Central Counterparty (i.e., a clearing house)
CEA	U.S. Commodity Exchange Act
CFTC	U.S. Commodity Futures Trading Commission
CSA	Credit support annex; part of the ISDA documentation
CTU	Centralized treasury unit
DCM	Designated contract market, the CEA registration category for an organized exchange that offers futures/options on futures and/or swaps for trading
DCO	Derivatives clearing organization, the CEA registration category for a clearing house for futures/options on futures and/or swaps
DCR	CFTC Division of Clearing and Risk
DFA	Dodd-Frank Act of 2010; established comprehensive regulatory scheme for OTC derivatives, primarily through Title VII, The Wall Street Transparency and Accountability Act

Acronyms




DMO	CFTC Division of Market Oversight
DSIO	CFTC Division of Swap Dealer and Intermediary Oversight
ECP	Eligible contract participant, which is the institutional / non-retail status a person is required to have to trade swaps bilaterally or on a SEF
EMIR	European Market Infrastructure Regulation
FBOT	Foreign board of trade; the term is used both generally to refer to a board of trade (exchange) located outside the U.S. and more specifically to a registration category under the CEA that covers a non-U.S. exchange that explicitly grants authority to market participants located in the U.S. to enter trades directly into its matching system
FCM	Futures commission merchant, an execution and/or clearing intermediary for derivatives between a market user and a DCM, SEF or DCO and which is permitted to receive and hold customer funds
FIA	Futures Industry Association
FSOC	U.S. Financial Stability Oversight Council

Acronyms




G-SIFI	Global systemically important financial institution
IB	Introducing broker, an intermediary that may execute swaps and/or futures/options on futures for market users but which is not permitted to receive or hold customer funds
ISDA	International Swaps and Derivatives Association
ISV	Independent software vendor
LEI	Legal entity identifier, the identifier that swap counterparties are required to obtain for purposes of reporting their swap transactions to an SDR
LSOC	Legally segregated, operationally commingled, the term used to describe the segregation requirements that apply to DCOs and FCMs with respect to holding funds of cleared swaps customers
MAT	A “made available to trade” determination by a SEF or DCM that it has a sufficient market in a swap that is subject to mandatory clearing, which triggers mandatory trading requirements
MIFID	European Commission Markets in Financial Instruments Directive

Acronyms



MSP	Major swap participant
MTF	Multilateral trading facility
NDF	Non-deliverable forward
Non-SD/MSP	Swap counterparty that is not a swap dealer or major swap participant
OTC	Over-the-counter, refers to derivatives executed bilaterally and “off-facility”
QCCP	Qualified central counterparty
RFQ	Request for quote
SD	Swap dealer
SDR	Swap data repository, a CFTC-registered facility authorized to accept and maintain swap trade reports and reports of continuation data
SEC	U.S. Securities and Exchange Commission
SEF	Swap execution facility, the CEA registration category for trading systems or platforms that are not exchanges and that offer swaps for trading

Acronyms



SIFI	Systemically important financial institution
SIFMU	Systemically important financial market utility
SRO	Self-regulatory organization; DCMs, SEFs and DCOs are SROs
STP	Straight through processing
TDR	Trade data repository, a data repository (such as an SDR) to which transaction terms are reported