LATHAM & WATKINS LLP

Customer Collateral Protection for Listed Derivatives in the US and UK

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Overview

Today's Agenda

I. US Futures Commission Merchants

II. UK Clearing Brokers

III. Summary: US-UK Comparison

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LATHAM & WATKINS LLP

I. US Futures Commission Merchants

A. Introduction

1. "Agency" Model of Client Clearing

A futures customer enters into a Client Agreement with a US futures commission merchant (**FCM**)

- Futures customer appoints FCM as its broker for purposes of executing and clearing futures transactions + facing the relevant clearinghouse
- In instances where the FCM is not a clearing member for the relevant clearinghouse on which the futures customer wishes to clear, the FCM will delegate services to its affiliates or third parties
  - If the FCM looks to an affiliate or third party to act as clearing broker, the FCM would nonetheless continue to retain the customer accounts for the futures customer
  - The affiliate or third-party clearing broker would then face the relevant clearinghouse in the trade

2. Client Agreement

B. Futures Accounts

1. Clearinghouse Account Structure

i. Omnibus Client Segregation

- Clearinghouse will distinguish between (i) FCM's assets and positions and (ii) cash, securities and other collateral (**funds**) held for the account of FCM's clients
- Futures customer funds are not exposed to losses of the FCM or other account losses with the clearinghouse
- Futures customer funds are commingled with those of other futures customers credited to the same account
  - FCM may have a number of omnibus accounts with the same clearinghouse
  - Client funds are exposed to losses connected with other client positions in the omnibus account
- Clearinghouse margin calls are done on a gross basis covering the positions in the omnibus account

ii. Types of Customer Accounts

- **Customer Segregated Account** (for futures and options)
- **30.7 Account** (for foreign futures and options)
- **Cleared Swaps Customer Account** (for cleared swaps)

B. Futures Accounts

2. FCM-Maintained Customer Accounts

i. Customer Account Types

FCM may maintain up to 3 different types of omnibus accounts for customers (**Customer Accounts**)

- **Customer Segregated Account** for customers that trade futures and options on futures entered into on or subject to the rules of a designated contract market (**DCM**) through an FCM (**Segregated Customers**)
- **30.7 Account** for customers that trade foreign futures or foreign options on futures through an FCM (**30.7 Customers**) listed on a foreign board of trade (**FBOT**)
- **Cleared Swaps Customer Account** for customers trading swaps that are cleared on a derivatives clearing organization (**DCO**) registered with the US Commodity Futures Trading Commission (**CFTC**)

B. Futures Accounts

2. FCM-Maintained Customer Accounts *(continued)*

ii. Customer Segregated Accounts

Funds deposited with an FCM by Segregated Customers, or that are otherwise required to be held for customers' benefit, to margin futures and options on futures contracts traded on US futures exchanges (*i.e.*, DCMs) are held in one or more omnibus account(s) (**Customer Segregated Funds**)

- **Segregation**

  Customer Segregated Funds of a Customer Segregated Account may not be used to meet the obligations of the FCM or any other person (including another customer)

- **Commingling / Depository**
  - All Customer Segregated Funds are commingled in one or more omnibus accounts and held with:
    - A US bank or trust company;
    - A non-US bank or trust company with >US$1 billion of regulatory capital;
    - An FCM; or
    - A DCO
  - Such commingled account must be properly titled to make clear that the funds at the depository belong to, and are being held for the benefit of, the FCM's Segregated Customers

B. Futures Accounts

2. FCM-Maintained Customer Accounts

ii. Customer Segregated Accounts *(continued)*

- **Currency / Location of Customer Segregated Funds**
  - Unless a customer provides instructions to the contrary, an FCM may hold Customer Segregated Funds in:
    - The U.S.;
    - A "**money center country**" (*i.e.,* Canada, France, Italy, Germany, Japan or the UK); or
    - The currency's country of origin
    - A DCO
  - FCM must hold sufficient USD in the U.S. to meet all USD obligations + sufficient funds in each other currency to meet obligations in such currency
  - Assets denominated in a currency may be held to meet obligations denominated in another currency (other than USD) if certain conditions are met

B. Futures Accounts

2. FCM-Maintained Customer Accounts *(continued)*

iii. 30.7 Accounts

Funds that 30.7 Customers deposit with an FCM (or that are otherwise required to be held for the benefit of 30.7 Customers) to margin futures and options on futures contracts traded on FBOTs (**30.7 Customer Funds**) are held in a 30.7 Account

- **Segregation**

  30.7 Customer Funds held in a 30.7 Account may not be used to meet the obligations of the FCM or any other person (including another customer)

- **Commingling/Depository**
  - All 30.7 Customer Funds may be commingled in an omnibus account and held with:
    - A US bank or trust company;
    - A non-US bank or trust company with >US$1 billion of regulatory capital;
    - An FCM;
    - A DCO;
    - The clearing organization of any FBOT
    - A foreign broker; or
    - Such clearing organization's or foreign broker's designated depositories

B. Futures Accounts

2. FCM-Maintained Customer Accounts

iii. 30.7 Accounts

- **Commingling/Depository** *(continued)*
  - Such commingled account must be properly titled to make clear that the funds at the depository belong to, and are being held for the benefit of, the FCM's 30.7 Customers
- **Location of Customer Segregated Funds**

  CFTC rules prohibit FCMs from holding 30.7 Customer Funds outside of the US, other than:
  - Such funds required to meet margin requirements of FBOTs and foreign brokers of foreign clearing organizations; and
  - An additional amount of up to 20% of the aggregate margin requirements to avoid daily transfers between US and non-US accounts

B. Futures Accounts

3. Commingling

i. Commingling of Funds Among Different Types of Customer Accounts

Funds required to be held in one type of Customer Account (*e.g.,* Customer Segregated Account) may not be commingled with funds required to be held in another (*e.g.,* 30.7 Account), except as the CFTC may permit by order

- **Examples**
  - January 13, 2017: LCH.Clearnet Limited (commingling and portfolio margining of cleared swaps, with futures and options and with foreign futures and foreign options)
  - May 30, 2014: ICE Clear Europe (commingling and portfolio margining of futures and options, with foreign futures and foreign options)
    - Amended Order (March 27, 2015): Extended to FCMs that carry contracts – but are not clearing members of – ICE Clear Europe

NOTE: FCM customer agreements typically include a provision that authorizes the FCM to transfer from one Customer Account, to any other Customer Account, such excess funds as may be required to avoid a margin call in such other account with respect to a particular customer

B. Futures Accounts

3. Commingling *(continued)*

ii. Commingling of Broker's Money in Customer Accounts

An FCM deposits a portion of its own funds in Customer Accounts (such excess funds, the FCM's **Residual Interest**), which are held for the FCM customers' exclusive benefit while held in a Customer Account

- **Determination of Amount**

  FCMs calculate the amount of Residual Interest to be deposited in Customer Accounts (**Targeted Residual Interest**) by considering, among other factors:

  - The nature of the FCM's customers, their general creditworthiness and their trading activity
  - The type of markets and products traded by the FCM's customers and by the FCM itself
  - The general volatility and liquidity of those markets / products
  - The FCM's own liquidity and capital needs
  - Historical trends in Customer Funds balances and customer debits
  - Minimum standards established by CFTC rules

B. Futures Accounts

3. Commingling

ii. Commingling of Broker's Money in Customer Accounts *(continued)*

- **Restrictions on Withdrawal**

  On any day, an FCM may not (in a single transaction or a series of transactions) withdraw, from any Customer Account, funds comprising its Residual Interest that are not made to or for customers' benefit, if such withdrawal would exceed 25% of the FCM's Residual Interest in such account (as reported on the daily segregation report as of the previous business day), unless the following requirements are met

  - The FCM's CEO, CFO or other senior official knowledgeable about the FCM's financial requirements and financial position preapproves the withdrawal (or series of withdrawals) in writing
  - The FCM files written notice of the withdrawal (or series of withdrawals) immediately thereafter with both (i) the CFTC and (ii) the FCM's designated self-regulatory organization (**DSRO**)

C. Regulatory Oversight of FCM-Maintained Accounts

1. Regulatory Reporting

i. Daily Reports

- Each FCM must calculate as of the close of business each business day, and submit a report to the CFTC and the FCM's DSRO, no later than noon the following business day, setting out:
  - Amount of Customer Funds required to be held in the Customer Account
  - Amount of Customer Funds actually held in the Customer Account
  - FCM's Residual Interest in the Customer Account
- Separate calculations are required for each type of Customer Account

ii. Account Deficiency Notices

An FCM must immediately notify the CFTC (and concurrently file a notice with the FCM's DSRO) upon the occurrence of either of the following:

- The amount of Residual Interest in any Customer Account falls below the FCM's Targeted Residual Interest for such account
- The FCM knows (or should know) that the total amount of funds on deposit in Customer Accounts is less than the amount required to be held

C. Regulatory Oversight of FCM-Maintained Accounts

1. Regulatory Reporting *(continued)*

iii. Twice-Monthly Reports

- Each FCM must submit a Segregated Investment Detail Report (**SIDR**) twice a month (on the 15th and last day of each month) to both the CFTC and the FCM's DSRO
- The SIDR must contain the following information with respect to each type of Customer Account:
  - The name and location of each bank, trust company, FCM, DCO or other depository/custodian holding Customer Funds
  - The total amount of Customer Funds held by each entity
  - The total amount of Customer Funds, cash and investments that each entity holds
  - Whether each entity is affiliated with the FCM

C. Regulatory Oversight of FCM-Maintained Accounts

2. DSRO Rules

FCMs must instruct each US and non-US depository that holds Customer Funds to confirm to the DSRO, on a daily basis, all account balances

- DSRO programs compare the depositories' reported daily balances with the FCMs' daily segregation reports, with any material discrepancies generating an immediate alert
- An FCM's DSRO conducts periodic examinations of the FCM, including confirmation that Customer Funds are being held in properly designated accounts
  - The CFTC may also conduct such examinations

D. Insolvency Risk

1. FCM Insolvency

- An FCM may default and face bankruptcy if:
  - i. One or more FCM customers default on their obligations to the FCM; and
  - ii. Application of the FCM's own available funds is not enough to cover the shortfall amount in Customer Funds required to be held in one or more Customer Accounts
- If the FCM is placed into bankruptcy:
  - The clearing FCM (if different) or DCO may apply Customer Funds from the omnibus accounts of non-defaulting customers to cover shortfall following application of available funds from defaulting FCM

    ** By contrast, the clearing FCM (if different) and DCO are prohibited from applying funds in an omnibus Cleared Swaps Customer Account attributable to non-defaulting Cleared Swaps Customers to meet the shortfall owing to the clearing FCM or DCO*

D. Insolvency Risk

1. FCM Insolvency *(continued)*

- The US Bankruptcy Code and CFTC rules provide that funds allocated to each Customer Account class (or readily traceable to a Customer Account class) must be allocated solely to that Customer Account class
- Properly segregated futures customer funds have a bankruptcy preference in the event of an FCM insolvency
- To the extent that such customer funds are insufficient to pay customer claims, customers will share *pro rata* in the distribution with unsecured creditors for the remainder
- Non-defaulting customers in any Customer Account class that have incurred a loss will share *pro rata* in any shortfall
  - Customers whose funds are held in another Customer Account Class that have not incurred a loss (*e.g.*, the 30.7 Account) will not be required to share in such shortfall
  - A shortfall in a Customer Account class may also make the transfer of the accounts of non-defaulting customers to another FCM difficult

D. Insolvency Risk

1. FCM Insolvency *(continued)*

- **Important Considerations**
  - Customers should consider an FCM's excess adjusted net capital, which is available to satisfy a defaulting customer's obligations to a DCO or clearing FCM
  - While the Residual Interest is the regulatory buffer imposed to cover FCM shortfalls, a DCO may also allow the FCM to hold excess margin at the DCO to protect against misuse of funds at the FCM level
  - US Bankruptcy Code broadly defines "**customer property**" to mean cash, a security or other property (or the proceeds of such cash, security or property) received, acquired or held by or for the FCM's account from or for the customer's account
    - Because customer property is not limited to only those funds required by the relevant exchange / DCO to margin open contracts, customer excess margin deposited with the FCM and the FCM's Residual Interest held in a Customer Account would, in the event of the FCM's insolvency, be entitled to the same protections as DCO / exchange-mandated margin

D. Insolvency Risk

2. Depository Insolvency

- The failure of any depository bank will be subject to the insolvency laws and resolution process of its home jurisdiction
- If a depository is subject to the US bankruptcy regime:
  - The Federal Deposit Insurance Act will be applicable
  - Depository will be subject to relevant rehabilitation or resolution process
    - FCM Customer Accounts may be transferred to another depository bank
  - If bank is liquidated, relevant US bank insolvency regime will apply

E. Collateral Management and Investments

1. Depository Selection

- An FCM may agree to hold a portion of its Customer Funds at a customer-selected depository if the FCM has determined that the depository is otherwise acceptable
  - Customer Funds are held in the FCM's name for the benefit of its customers generally and may not be used by the FCM, depository or any other person for its own account
  - On the depository's books, accounts are separately accounted for and segregated from any other account held by the FCM
  - FCMs may limit the number of depositories at which they maintain Customer Accounts
  - Depository must meet relevant criteria and must provide FCM with written acknowledgement that both:
    - Such 30.7 Funds or Customer Segregated Funds will be separately accounted for on the depository's books
    - Such Customer Funds may not be used to satisfy, secure or guarantee any obligations of the FCM, the depository or for the account of someone else

E. Collateral Management and Investments

2. Account Information

While customer statements generally do not indicate where a customer's funds are held, an FCM will provide upon customer request the depositories at which the FCM holds Customer Funds

3. Third-Party Custodians

Third-party custodial accounts (including accounts maintained in customer's custody) are not permitted for Customer Segregated Accounts and 30.7 Accounts

4. Depository Location

FCM must hold Customer Funds in depositories located in the U.S., and may not transfer funds outside of the U.S. (except upon customer instruction) if the customer both:

- Is located in the U.S.
- Has deposited USD (or USD-denominated securities) to margin futures and options on futures contracts traded on US futures exchanges

E. Collateral Management and Investments

5. 30.7 Customer Funds

FCM (i) must deposit 30.7 Customer Funds under the laws and regulations of the foreign jurisdiction that provide the greatest degree of protection to such funds and (ii) may not (by contract or otherwise) waive any of the protections afforded customer funds under the foreign jurisdiction's laws

- Such funds are subject to relevant local laws
- 30.7 Customer Funds held outside of the U.S. to margin transactions on FBOTs do not receive the same protections under US law (including the US Bankruptcy Code) as do Customer Segregated Funds or Cleared Swaps Customer Collateral

F. Investment of Customer Funds

1. Permitted Investment of Customer Funds

Investments of customer funds are made on an omnibus basis; FCMs cannot identify specific investments for the benefit of specific customers

i. Permitted Investments

- US government securities
- Municipal securities
- US agency obligations
- Certificates of deposit issued by certain banks
- Commercial paper
- Corporate notes or bonds
- Interests in money market mutual funds
- Repurchase (**repo**) and reverse repurchase (**reverse repo**) transactions
  - FCM may engage in repo and reverse repo transactions with non-affiliated registered dealers subject to certain restrictions

F. Investment of Customer Funds

1. Permitted Investment of Customer Funds *(continued)*

ii. Duration

The duration of the securities in which an FCM invests customer funds cannot exceed, on average, two years (repos no more than one business day or reversal on demand)

iii. Gains

FCM may retain all gains earned in connection with the investment of Customer Funds

iv. Losses

FCM is responsible for investment losses incurred in connection with the investment of Customer Funds

v. Interest

FCM and customer may agree bilaterally that FCM will pay the customer interest on the funds deposited

vi. Concentration Limits

Concentration limits apply

F. Investment of Customer Funds

2. Pledging, Hypothecation and Rehypothecation

FCM may (a) pledge, hypothecate and rehypothecate customer securities in order to post such securities with a DCO to margin the customer's futures transactions and (b) hypothecate and rehypothecate the funds / securities of all customers whose funds are held in the omnibus Customer Account

i. Collateral Transformation

FCM may pledge, hypothecate and rehypothecate non-permitted customer-owned securities to DCO-accepted securities (**collateral transformation**)

ii. Repos and Reverse Repos

FCM may hypothecate and rehypothecate securities in order to enter into repo and reverse repo transactions with permitted third parties (*i.e.,* bank or broker-dealer)

iii. Transaction Terms

Collateral transformation transactions and repos/reverse repos (a) must be completed on a DVP basis and (b) will not be recognized as completed until the funds / securities are received by the custodian of the FCM's Customer Account

G. Foreign Carrying Brokers

1. Foreign Broker Failure

- If the foreign broker carrying 30.7 Customer positions fails, the broker will be liquidated in accordance with the laws of its home jurisdiction (which may differ significantly from the US Bankruptcy Code)
- Return of 30.7 Customer Funds to the U.S. would likely be delayed and subject to the failed foreign broker's (and possible other intervening foreign brokers', if multiple foreign brokers were used to process the US customers' transactions on foreign markets) administration/liquidation costs, in accordance with the law of the applicable jurisdiction(s)

G. Foreign Carrying Brokers

2. US FCM Failure

- If the foreign broker does not fail, but the US customer's FCM fails, the return of funds held outside of the U.S. may nonetheless be delayed
- If a US FCM were to fail and there was a shortfall in 30.7 Customer Funds arising from losses in one foreign jurisdiction, those losses would be shared pro rata by all of the FCM's 30.7 Customers (including customers that did not engage in trading in that jurisdiction)

3. Affiliate Brokers

- FCM may use one or more affiliates to carry and clear transactions on FBOTs if the affiliate(s) meet(s) the FCM-established criteria for depositories holding Customer Funds
- Failure of a US FCM or its affiliate could cause all of the affiliated entities to fail or be placed into insolvency proceedings (under the local jurisdiction's insolvency laws)

II. UK Clearing Brokers

A. Introduction

1. Types of Client Agreements

i. Client Money

Money delivered by futures customer to a UK clearing member (**CM**) is held in accordance with the provisions of the Client Asset Sourcebook (**Client Money Rules**) published by the Financial Conduct Authority (**FCA**), a regulatory authority in the UK

- Securities will be transferred by way of full title transfer

ii. Title Transfer

Money and securities are transferred by futures customer to CM by way of full title transfer

2. "Principal" Model of Client Clearing

Two separate, but related, transactions are entered into between:

i. Client and CM, each party acting as principal

ii. CM (entering into an equal and opposite transaction) and the clearinghouse, again with each party acting as principal

B. Futures Accounts

1. Clearinghouse Account Structure

i. Omnibus Client Segregation

- Assets of client are not exposed to losses of CM or other accounts with the CCP
- Assets of client are exposed to losses connected with the positions of other clients in the account
- **Types of Omnibus Accounts**

I. Net Omnibus Account

- CCP calls for margin on a net basis
- CM calls for margin on a gross basis
- Excess margin may be retained by CM

II. Gross Omnibus Account

- CCP calls for margin on a gross basis
- Arguably easier to port upon a CM insolvency than a Net Omnibus Account as transferee clearing member is likely to require gross margin

B. Futures Accounts

1. Clearinghouse Account Structure *(continued)*

ii. Individual Client Segregation

- Assets of client not exposed to losses of CM or other clients
- Excess margin shall be posted to the CCP (not held by CM)
- Whilst the account mitigates CM risk, it does not remove transit risk
- Should be easier to port upon a CM insolvency than omnibus account

B. Futures Accounts

2. Clearing Member-Maintained Customer Accounts

i. Client Money *(applies to excess margin)*

a. Exclusions from Client Money Rules

- Fees / commissions
- CM does not receive money back from CCP

b. Permitted Uses of Client Money

- Collateral (including excess) to the CCP
- Collateral to meet futures customer's obligations to an intermediate broker

c. Client Money Accounts

CM must ensure client money deposited with third party is identified separately from non-client money

d. Currency of Client Money

CM may segregate client money in a different currency from that in which it was received, subject to daily FX adjustments

ii. Title Transfer

- Any money will be the property of CM
- To the extent CM retains excess collateral, a client will be exposed to the credit risk of CM

B. Futures Accounts

3. Commingling

i. Commingling of Funds Among Different Types of Customer Accounts

- Upon a "**Primary Pooling Event**" (which relates to the failure of CM), all client money held by CM (except money allocated to a Sub-Pool) will be pooled together (the **General Pool**) and the futures customer will have a proprietary claim against the General Pool for its ratable share
- CM may choose to segregate client money for clients who have chosen a Net Omnibus Account with the CCP by creating a "**Sub-Pool**" of such client money to facilitate porting
  - Upon a Primary Pooling Event, the Sub-Pool is either (i) transferred to facilitate porting or (ii) distributed to the relevant clients
  - CM would need client consent to create such a Sub-Pool
- "**Secondary Pooling Events**" include the failure of a third party with which CM has deposited client money
  - In general, where CM has not chosen to make good any shortfall itself, losses will be shared amongst all the clients who have elected client money protection

B. Futures Accounts

3. Commingling *(continued)*

ii. Commingling of Broker's Money in Customer Accounts

- CM must ensure any money other than client money deposited in a Client Bank Account is promptly paid out, unless required to open the account or keep the account open
- If prudent to do so to prevent a shortfall in client money on the occurrence of a Primary Pooling Event, CM may pay its own money into a Client Bank Account
  - This is "client money" for purposes of Client Money Rules
  - If CM no longer considers it prudent to retain this money in its Client Bank Account, then CM may (i) cease to treat this money as client money and (ii) withdraw it as an excess

C. Regulatory Oversight of CM-Maintained Accounts

1. Client Money

i. Daily Internal Reconciliation

CM must reconcile client money for each client with internal records each business day

ii. Monthly External Reconciliation

CM must reconcile internal records against third-party records once a month, or (if it undertakes daily transactions) each business day

iii. Discrepancies

Where the balance CM holds has missing funds, CM shall pay its own money to fix this on the day of reconciliation

iv. Notifications to the FCA

CM must notify regulator if its internal records are materially out of date or inaccurate, or if it fails to conduct an internal client money reconciliation, pay any shortfall, withdraw any excess or resolve any discrepancy

2. Title Transfer

CM may use money in its discretion

D. Insolvency Risk

1. Clearing Member Insolvency

i. Client Money

- "**Primary Pooling Event**" includes, among other things, CM insolvency
  - If CM becomes insolvent, (i) all client money is pooled and (ii) each client who has chosen client money protection has a proprietary claim ratable to their client money entitlement against the General Pool
  - The General Pool will not form part of the insolvent estate of CM
  - It may be the case that CM has chosen to set up Sub-Pools for Net Omnibus Accounts, in which case these will not form part of the General Pool
- If client monies held at the CCP through an individual client account or omnibus client account are remitted direct to CM then:
  - Amounts from an individual client account must be distributed to the individual client and will not form part of the General Pool of client money
  - Amounts from an omnibus client account will either (i) form part of the General Pool or Sub-Pool, as applicable, or (ii) be distributed direct to the relevant clients if CM holds no excess margin and the amounts attributable to each client are easily verifiable

D. Insolvency Risk

1. Clearing Member Insolvency

i. Client Money *(continued)*

- If CCP-held positions and collateral are ported, any balance remaining shall be returned either (i) directly to the client, where the CCP knows its identity, or (ii) to CM for onward distribution in accordance with the above bullet point

ii. Title Transfer

Claim as unsecured creditor

D. Insolvency Risk

2. Depository Insolvency

i. Client Money

"**Secondary Pooling Event**" includes, among other things, account bank insolvency

- CM can pay an amount equal to any lost sums to a Client Bank Account at an unaffected bank
- If CM chooses not to, then:
  - **General Client Bank Account**
    Money held in every General Client Bank Account (not just accounts with the insolvent account bank) is treated as a single pool and any shortfalls will be borne ratably by all those clients
  - **Designated Client Bank Account**
    Any shortfalls in the amount of client money held at that failing bank in Designated Client Bank Accounts will be borne ratably by all clients whose client money was held in a Designated Client Bank Account at the failed third-party bank
  - **Designated Client Fund Account**
    Any money held with the failed bank must be treated as pooled with any other Designated Client Fund Accounts which contain part of the same designated fund and any shortfalls will be borne ratably by each client whose money is held in the designated fund

D. Insolvency Risk

2. Depository Insolvency *(continued)*

ii. Title Transfer

Unless the insolvency of a third-party account bank caused a CM insolvency, it would not affect the client

3. Third-Party Segregated Accounts

i. Client Money

There is no option under UK regulations for the client to require CM to maintain a Client Bank Account solely for that client

- Even where CM does maintain such an account, there will always be a degree of commingling with other clients

ii. Title Transfer

As title is transferred to CM, such money may be used by CM in its discretion and the client has no right to request it is held in any particular format

E. Collateral Management and Investments

1. Client Money

i. Permitted Depositories

Client money may only be held in accounts opened with a central bank, European bank, third country authorised bank or a qualifying money market fund

ii. Clearing Member-Held Client Money

CM must hold at least 80% of the total client money held by CM in its Client Bank Accounts with non-affiliate entities

iii. Client Control Over Client Funds

Client has no control other than:

- CM must give the client the right to oppose the placement of its money in a qualifying money market fund
- A Designated Client Bank Account or Designated Client Fund Account may only be used for a client where the client consents

2. Title Transfer

As title is transferred to CM, such money may be used by CM in its discretion

F. Investment of Customer Funds

1. Client Money

No investments are permitted – just the permitted accounts

2. Title Transfer

As title is transferred to CM, such money may be used by CM in its discretion

G. Foreign Carrying Brokers

1. Trades Executed by Another Broker

i. Client Money

a. Intermediate Broker Failure

- In theory, monies credited to an intermediate broker's Client Transaction Account should not form part of the estate of insolvent intermediate broker
  - However, the intermediate broker will be liquidated in accordance with the laws of its jurisdiction of organisation/ incorporation, which laws may differ from the UK insolvency rules
- The intermediate broker is not required to comply with client money rules to the extent it has used monies in the Client Transaction Account (*e.g.*, delivering collateral to another contractual counterparty)
  - This arrangement will be governed by the local regulations applicable to the intermediate broker

b. Clearing Member Failure

This will result in a Primary Pooling Event, and monies credited to a Client Transaction Account will form part of the pool of assets

ii. Title Transfer

The futures customer is exposed to the insolvency regime applicable to the defaulting intermediate broker

G. Foreign Carrying Brokers

2. Trades Cleared by CM on Behalf of Another Broker

- Where CM acts as clearing member in relation to a European clearinghouse, it must offer clients the choice between (at least) omnibus client segregation and individual client segregation
  - Where a futures customer has appointed FCM as its broker and clears a transaction on an EMIR-compliant clearinghouse, FCM may choose to do so via CM as clearing member, who will open an omnibus client account in the name of FCM's clients
- This means:
  i. Futures customer will not have the option of individual client segregation (so will be exposed to the risk of other clients in the account)
  ii. It may be difficult for CCP to identify names of clients in omnibus client account (this will make porting harder)

III. Summary: US-UK Comparison

▪ FCM / Clearing Member Default Waterfall

	US Futures Commission Merchant	UK Clearing Member
	I. Upon an FCM Default with Respect to a Customer Omnibus Account	**I. Upon a CM Default (incl. Bankruptcy) with Respect to an Omnibus or Individually Segregated Customer Account**
Excess Margin	Excess margin is not customarily held with the CCP; to the extent a futures customer has excess margin in an omnibus account at the CCP, CCP may apply any excess customer margin held with the CCP to meet the FCM's obligations with respect to the customer omnibus account	**<u>Individual Account</u>** Excess margin is held with the CCP and will not be used to meet the obligations of other CM customers **<u>Omnibus Account</u>** Excess margin is not held with the CCP; to the extent a customer has excess margin in an omnibus account at the CCP, it will be used to discharge the obligations of other customers in the omnibus account
Porting	CCP will attempt to transfer the assets and positions held in the customer omnibus account to one or more non-defaulting FCMs	CCP will attempt to transfer the assets and positions held in the omnibus / individually segregated customer account to one or more non-defaulting CMs

III. Summary: US-UK Comparison

▪ FCM / Clearing Member Default Waterfall *(continued)*

	US Futures Commission Merchant	UK Clearing Member
	II. Upon an FCM Bankruptcy	**I. Upon a CM Bankruptcy**
Porting	CCP may not attempt to transfer the assets and positions held in the customer omnibus account, except as directed by the bankruptcy trustee (except a CCP may, under certain circumstances, port positions within 7 days of an order of relief)	No equivalent restriction as in the U.S.
Liquidation	CCP may net and liquidate all the positions held in the customer omnibus account (incl. defaulting and non-defaulting customers), and use the liquidation proceeds to meet the defaulting FCM's obligations under the customer omnibus accounts • Customer has preferential right against its *pro rata* share of proceeds in the customer omnibus accounts • If liquidated positions not sufficient to cover customer claims, then customers would share *pro rata* in the shortfall with FCM's other unsecured creditors • If a custodial bank defaults, to the extent there is a shortfall in the customer accounts, each customer will bear such loss on a *pro rata* basis (*i.e.,* the customers take credit risk on the custodians); nothing prohibits FCM from making good on losses suffered by its customers due to a custodian default	**Client Money Version** CM will have been required to diversify funds across multiple custodians, with such funds commingled with funds of all other customers who have chosen client money protection; customer has proprietary right against its *pro rata* share of such funds To the extent the CM defaults, customer's credit exposure to the defaulting CM is reduced; note, however: • If there is a shortfall in the client monies, each customer will bear such loss on a *pro rata* basis • If a custodian bank defaults, to the extent there is a shortfall in client monies and CM has chosen not to make good on such loss, each customer will bear such loss on a *pro rata* basis (*i.e.,* customers take on custodian credit risk) **Title Transfer Version** Customer exposed to defaulting CM credit risk

III. Summary: US-UK Comparison

Considerations in Choosing a Clearing Broker/FCM

- Jurisdiction of where you will trade
- Applicable Customer Collateral/Client Money Rules or Title Transfer
- Porting commitments
- Margin levels
- Reinvestment of customer assets
- Segregation of customer assets

Customer Collateral Protection: Q&A

Questions?

LATHAM & WATKINS LLP

Speakers

Yvette D. Valdez

Yvette Valdez is counsel in the New York office of Latham & Watkins. Ms. Valdez is a member of the firm's Financial Institutions Industry Group and the Derivatives Practice Group.

Profile

Ms. Valdez has significant experience in the representation of dealers, intermediaries and end-users in connection with derivatives legal and regulatory matters under the Dodd-Frank Act as well as related CFTC, SEC and prudential regulation. Ms. Valdez has extensive experience representing investment banks, corporations, private equity firms and asset managers in structured investments and derivatives transactions, which include interest rate and credit derivatives, foreign exchange transactions, total return swaps, commodity transactions, futures and options. Ms. Valdez has developed an advisory practice applying these core regulatory principles to cryptocurrency derivatives and smart contracts. Ms. Valdez also has substantial experience in representing clients in structuring finance-linked hedging structures in the energy, infrastructure and asset finance industry as well as representing agriculture, power and energy participants with their commodity hedging transactions on and off-exchange.

Ms. Valdez's regulatory practice consists of assisting foreign and domestic investment banks, futures commission merchants, introducing brokers, broker-dealers and commodity pools with their regulatory compliance requirements under the Dodd-Frank Act as well as advising buy-side clients in connection with their exchange-trading, clearing and trade execution requirements. She has also advised clients in connection with the registration and compliance obligations of swap execution facilities.

Speaking Engagements

- Cryptocurrencies and Blockchain Technology - Truth or Dare, hosted by Futures Industry Association, Law & Compliance, May 2016
- Bitcoin, Blockchain and Finance, a Panel on Bitcoin Derivatives and Regulation hosted by Cardozo Law School, November 2015
- The 2014 ISDA Credit Derivatives Definitions: What the Buy-side Needs to Know, A Co-Hosted Webcast by Latham & Watkins and The MFA, July 2014

Experience

Ms. Valdez's experience includes the representation of:

- Representation of Landesbank Baden-Wurttemberg and Banco de Crédito e Inversiones regarding Dodd-Frank and CFTC regulatory requirements in respect of swap dealer and commodity pool operator/trading advisor regulation*
- SunTrust Bank, Deutsche Bank, Credit Suisse, Credit Agricole CIB, BNP Paribas, Citibank N.A, Banco de Crédito e Inversiones and SMBC in connection with fixed-income, foreign exchange, commodity and total return swap derivatives transactions*

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Education

JD, Columbia University School of Law, 2005, Harlan Fiske Stone Scholar

B.A., Emory University, 2000, magna cum laude

Bar Qualifications

New York

Languages

English

Spanish

LATHAM & WATKINS LLP

Speakers

Yvette D. Valdez

Experience *(continued)*

- RBS in connection with the creation of an options trading platform for an insurer
- Major investment banks in connection with the creation of derivative platforms for fixed income derivatives and general representation in relation to such derivative platforms*
- Private equity firms and funds in connection with fixed income and credit derivatives transactions*
- Various energy and gas companies in connection with hedging documentation in commodity transactions including emission allowances, power and fuel*
- Foreign financial institutions in connection with clearing and trade execution on-boarding*
- Financial institutions in connection with hedging and credit enhancement transactions and risk management structures involving derivatives, including total return swaps, credit default swaps and forward delivery agreements*
- Foreign financial institutions in Latin America, in connection with the execution of derivatives transactions with various dealers in respect of the bank's various foreign exchange transactions and currency options and swaps with other dealers*
- Commercial and investment banks in connection with termination and settlement as well as collateral obligations of various derivatives transactions in respect of the Lehman Brothers bankruptcy*
- Investment managers in connection with commodity pool operator and commodity trading advisor regulatory and compliance obligations*

Thought Leadership

- Co-author, Marketing Non-US Private Equity Funds in the United States: A Roadmap through the Various Regulations and Tax Implications, *Journal of Investment Compliance*, May 2017
- Co-author, Practical Law, Reference Guide to Practice Note, The Dodd-Frank Act: Margin Posting and Collection Rules for Uncleared Swaps, September 2016
- Co-author, Evolution of the CFTC's Whistleblower Program, *New York University Compliance and Enforcement*, September 2016
- Co-author, Dodd-Frank Almost 6 Years Later: Where Are We Now? Energy-Related Derivatives Regulation, Bloomberg BNA: Securities Regulation and Law Report, March 2016
- Co-author, Final exemptive order regarding cross-border application of swap regulations, Lexology, August 22, 2013*
- Co-author, CFTC approves final interpretive guidance with respect to the cross-border application of certain swap provision of the Commodity Exchange Act, Lexology, August 21, 2013*
- Co-author, ISDA August 2012 Dodd-Frank Protocol, Lexology, October 26, 2012*
- Co-author, CFTC and SEC Publish Rules Defining Entities That Will Be Classified as Dealers, Major Participants in Derivatives Market, Bloomberg BNA: Securities Regulation & Law Report, Volume 44, Number 24, June 11, 2012*
- Co-author, Swap Dealers, Major Swap Participants and Eligible Contract Participants, Derivatives Week: The Learning Curve, Volume XXI, Number 20, May 21, 2012*
- Co-author, Lehman Bankruptcy Court Denies Contractual Right to Triangular Setoff, The Journal on the Law of Investment & Risk Management Products: Futures & Derivatives Law, Volume 32, Issue 2, February 2012*
- Co-author, International Swaps & Derivatives Association, Inc., ISDA Collateral Committee, Market Review of OTC Bilateral Collateralization Practices, March 2010*

* Completed while at a previous firm

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FIA

Speakers

Shatha H. Ali

Shatha Ali is counsel in the Corporate Department of the London office of Latham & Watkins and a member of the firm's Financial Institutions Industry Group and the Derivatives Practice Group. Ms. Ali focuses her practice on transactional and regulatory advice relating to derivatives.

Counsel, London

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Profile

Ms. Ali has experience in over-the-counter and structured finance transactions across a range of asset classes including rates, equity and credit, and has advised on related insolvency and dispute resolution issues.

Experience

Ms. Ali's recent experience includes advising:

- A clearinghouse with respect to its European client clearing offering. This has involved structuring products which offer end-users the ability to access cleared products through clearing members, whilst reducing their exposure to such clearing members and maintaining the stability of the system.
- A number of institutions (both large European financial institutions and non-financial counterparties) with respect to their obligations under EMIR and the procedures, processes and documents to be implemented to address the issues identified.

Education

Legal Practice Course, BPP Law School, 2004, with Distinction

Law Degree, King's College London, 2003, 1st Class, Helen Gibbons Prize in Commercial Law

Bar Qualifications

England and Wales (Solicitor)

LATHAM & WATKINS LLP

Speakers

Polly R. Ehrman

Polly Ehrman is an associate in the Corporate Department of the London office of Latham & Watkins and a member of the firm's Financial Institutions Industry Group and the Derivatives Practice Group. Ms. Ehrman focuses her practice on transactional and regulatory advice relating to derivatives.

Associate, London

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Profile

Ms. Ehrman has experience in over-the-counter and structured finance transactions across a range of asset classes including rates, equity and credit, and has advised on related insolvency and dispute resolution issues.

Education

Legal Practice Course, College of Law, London, 2008

B.A. (Hons) Law, Cambridge University, 2007

Bar Qualifications

England and Wales (Solicitor)

LATHAM & WATKINS LLP

Speakers

J. Ashley Weeks

Ashley Weeks is an associate in the Corporate Department of the New York office of Latham & Watkins and a member of the firm's Financial Institutions Industry Group and Derivatives Practice Group. Ms. Weeks focuses her practice on regulatory, compliance and transactional issues relating to commodities, securities and derivatives products.

Associate, New York

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Profile

Ms. Weeks has experience representing investment banks, corporations and asset managers in structured investments and derivatives transactions, including interest rate derivatives, foreign exchange transactions, equity derivatives and commodity transactions. Ms. Weeks also has experience representing clients in structuring finance-linked hedging structures in the project finance industry.

Ms. Weeks maintains a regulatory practice consisting of assisting financial institutions, corporate end-users and other market participants with regulatory compliance matters under the Dodd-Frank Act, as well as with respect to other CFTC, SEC and prudential regulatory matters.

Thought Leadership

- Co-author, Marketing Non-US Private Equity Funds in the United States: A Roadmap through the Various Regulations and Tax Implications, *Journal of Investment Compliance*, May 2017
- Co-author, The Dodd-Frank Act: Margin Posting and Collection Rules for Uncleared Swaps, *Practical Law, Reference Guide to Practice Note*, September 2016
- Co-author, Evolution of the CFTC's Whistleblower Program, *New York University Compliance and Enforcement Blog*, September 2016
- Co-author, Dodd-Frank Almost 6 Years Later: Where Are We Now? Energy-Related Derivatives Regulation, *Bloomberg BNA: Securities Regulation and Law Report*, March 2016

Education

J.D., University of Virginia School of Law, 2014

B.A., University of North Carolina, 2010

Bar Qualifications

New York

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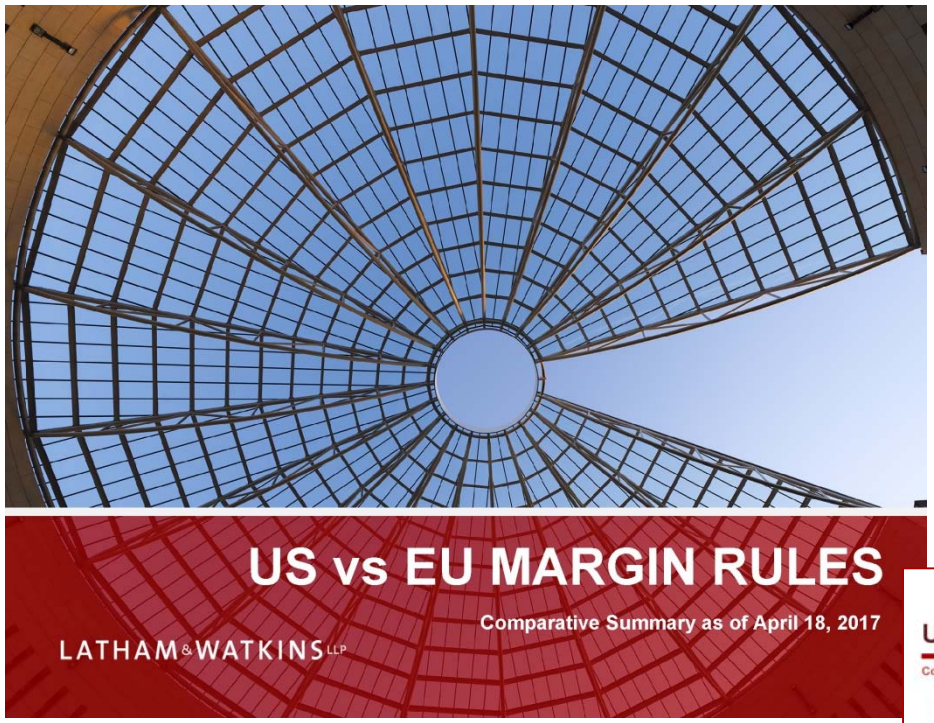
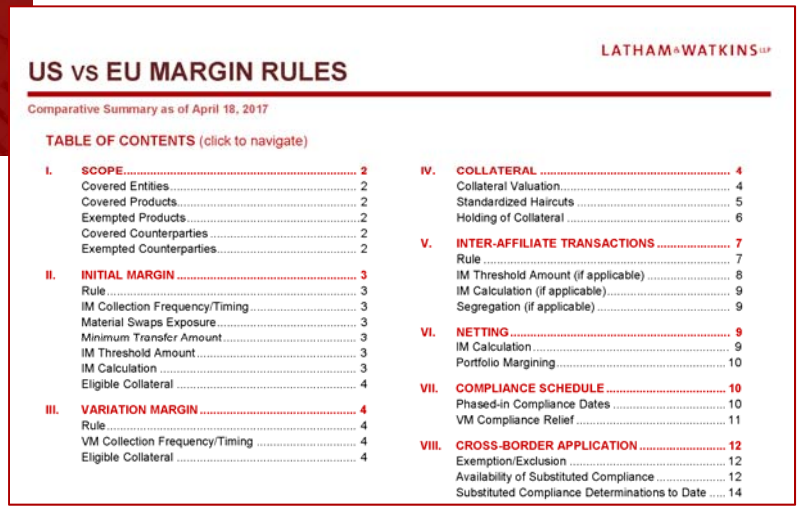
US-EU Margin Rules Reference Guide



Our reference guide has helped financial institutions, financial end-users and other market participants determine applicable initial and variation margin requirements when facing US- and EU-regulated derivatives counterparties.

As regulators and market practice clarify the scope and application of the rules in the coming months, we will update this chart to reflect the most current understanding.

Bookmark https://www.lw.com/thoughtLeadership/US-EU-margin-rules-reference-guide to ensure access to the most recent version of the guide.



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US vs EU MARGIN RULES

Comparative Summary as of April 18, 2017

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LATHAM&WATKINS LLP

Our Derivatives, Commodities & Futures Practice

Hands-On Experience

- Latham has practical knowledge of derivatives across all principal asset classes including interest rates, currencies, commodities, equities and credit.
- Latham lawyers are actively involved in assisting market participants, trade associations and other interested parties in responding to proposed rulemakings by the CFTC and SEC relating to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 in order to encourage regulators to implement final rules that will support fair, efficient and well-functioning markets without imposing undue burdens or risks on Latham's clients and market participants as a whole.
- We have a thorough understanding of the regulatory challenges that affect our clients at national, European and international levels, enabling us to deliver incisive levels, enabling us to deliver incisive advice on critical financial regulatory issues arising under EMIR and MiFID. In particular, our team advises our corporate clients on all aspects of regulatory and risk management, enforcement and compliance work under EMIR across multiple jurisdictions.
- Our regulatory expertise under EMIR is also backed by the strength of our derivatives practitioners who advise clients with respect to the full range of over-the-counter and exchange-traded derivative products.

Regulatory Compliance

- Latham's foothold in the market allows our lawyers to provide our clients with regulatory advice across key jurisdictions, including the United States, the European Union and Asia.
- These include domestic and non-US entities, both financial and non-financial; global enterprises with affiliates throughout the world, foreign boards of trade and non-US intermediaries.
- Given the broad extraterritorial application of Dodd-Frank and EMIR, the ability to manage compliance across jurisdictional and entity lines is crucial.

Enforcement and Litigation

The Latham team advises clients in complex investigations and litigation matters involving derivatives, utilizing our experience with the CFTC and other regulators to assist clients in navigating a complex and rapidly developing regulatory and enforcement environment.

LATHAM & WATKINS LLP

Our Financial Institutions Industry Group

Integrated Practice and Market Knowledge

Latham's Financial Institutions Group understands, anticipates and addresses the issues facing our financial institution clients, from long-standing traditional players to new market entrants. Through our globally integrated, regulatory, transactional and litigation practices, we provide clients with the advice needed to navigate today's highly regulated capital and financial markets.

Latham has its finger on the pulse of developments in markets and regulations throughout the world. Lawyers in all major money centers advise clients in the following principal practice areas:

- Broker-dealer regulation
- Bank regulation
- Derivatives regulation
- Capital markets/derivatives/equity-linked financial products
- Commodities, futures and swaps
- Investment/asset management
- M&A consortia transactions in financial services (FinTech)
- Litigation and arbitration
- Investigations, compliance, regulatory enforcement & rule enforcement by self-regulatory bodies

Financial Regulatory Experience

We have extensive experience in the full range of regulations and business issues facing financial institutions and the markets in which they operate. Clients include domestic and foreign banks and investment banks, investment firms, broker-dealers, payment service providers, financial investors, FinTech providers (including emerging companies), deposit-guarantee schemes, bank associations, public sector clients, stock exchanges and trading platforms, among others.

We advise clients on the expansion and introduction of foreign financial products into local markets, as well as governments and financial regulators in the development of legislation, rulemaking and legal policy such as design of listing rules, securities laws, financial markets regulation and other law reform.

"They offer incredible quality and are extremely authoritative and thorough. They're thoughtful and think through the longer-range implications."

"The team's preparation is total, resulting in virtually zero wasted time or energy."

Chambers USA 2016: Financial Services Regulation - Nationwide

Innovation in Legal Expertise

The *Financial Times* presented Latham with the award for "Innovation in Legal Expertise: Accessing New Markets and Capital" in their Innovative Lawyer Awards 2016.

Financial Times Innovative Lawyer Awards 2016

FINANCIAL TIMES

LATHAM & WATKINS LLP

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