Proposed Part 190

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Risk Management and Capital Relief Issues

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Proposed Part 190 - Introduction

In the United States, "commodity brokers," as defined in the Bankruptcy Code, are not eligible to commence reorganization cases under Chapter 11.

"Commodity brokers" include entities registered with the Commodity Futures Trading Commission (the **CFTC**) as "futures commission merchants" (**FCMs**) or "derivatives clearing organizations" (**DCOs**).

"Commodity brokers" are instead subject to liquidation proceedings under Subchapter IV of Chapter 7 of the Bankruptcy Code.

DCOs that are "financial market utilities" (**FMUs**) that have been designed as systemically important by the FSOC, including CME and ICE (and OCC to the extent of its commodity operations), are potentially subject to resolution by the FDIC as a "covered financial company" under the provisions of the Orderly Liquidation Authority (**OLA**) (12 USC 5381-5394).

- But under OLA, subchapter IV still applies to the distribution of customer and member property if the covered financial company is a "commodity broker."

The Liquidation of Commodity Brokers – Background

Subchapter IV is specific to the liquidation of commodity brokers, but deals with many issues at a fairly high level, and both the Commodity Exchange Act and Subchapter IV contemplate that Subchapter IV would be supplemented by CFTC rules.

In 1983, the CFTC proposed and adopted Part 190 (17 CFR Part 190) bankruptcy rules (**Part 190**), which establish a more complete framework for the liquidation of commodity brokers.

Current Part 190 mainly deals with FCM issues and only lightly addresses the liquidation of DCOs as a separate subject.

Though Part 190 has been amended several times since its adoption, in recent years it has been the subject of increased focus of efforts to overhaul and modernize it.

Proposed Part 190 - Introduction

The last financial crisis, in particular the bankruptcy of MF Global, has provided practical modern experience on how Part 190 works.

FCMs and DCOs have significantly greater presence than in 1983:

- Dodd-Frank's swap clearing mandate provides for swaps to be cleared through FCMs and DCOs.
- Part 190 features in cross-border regulatory discussions and is one of the cornerstones of the customer protection regime in the U.S.
- Institutions focus on the nature of counterparty risk borne by participants in the clearing chain for netting, risk management, capital purposes.
- Domestic and cross-border regulations on these issues turn on the treatment of positions and assets in the insolvency of a clearing member (**CM**) or central counterparty (**CCP**).
- Significant focus on CCP end of the waterfall issues, CCP resilience, recovery and resolution with "no creditor worse off" being a key concern.

Proposed Part 190 - Introduction

On September 28, 2017, the Part 190 Subcommittee of the Business Law section of the American Bar Association submitted model Part 190 rules to the CFTC for its review and consideration.

On April 14, 2020, the CFTC published a notice of proposed rulemaking with respect to Part 190 that is informed by, but not identical to, the ABA model Part 190 rules. The comment period for the proposal currently expires on July 13, 2020.

Risk Management and Capital Treatment – Overview of Netting

- A positive netting conclusion requires an analysis of whether obligations owed between two parties will be netted in the event of an insolvency of such that a single amount will be due between them.
- ISDA and FIA have procured various industry netting opinions for the benefit of their members. Various CCPs and members may have also procured netting opinions separately.
- The ISDA-FIA US client reliance opinion considers netting in the event of a FCM or DCO bankruptcy and focuses its analysis on whether a customer or member, as the case may be, would have a net claim under Part 190 under the calculation of such party's "net equity" under Part 190.

Risk Management and Capital Treatment – US Bankruptcy Remoteness of IM

The Federal banking regulators adopted final regulatory capital rules implementing Basel III for banking organizations on October 11, 2013.

- Such rules establish, among other things, the methodologies that an institution must use to calculate risk-weighted assets for "cleared transactions." *See* 12 CFR 3.35 (OCC), 217.35 (FRB) and 324.35 (FDIC).
- To determine the risk-weighted asset amount for a cleared transaction, a clearing member client must multiply the trade exposure amount for the cleared transaction, as calculated, by the applicable risk weight appropriate for the cleared transaction.
  - The trade exposure amount equals:
    - The exposure amount for the derivative contract or netting set of derivative contracts, calculated using the methodology used to calculate exposure amount for OTC derivative contracts under § __.34; plus
    - The fair value of the collateral posted by the clearing member client and held by the CCP, clearing member, or custodian in a manner that is not bankruptcy remote.

Risk Management and Capital Treatment – US Bankruptcy Remoteness of IM

Collateral posted by an institution that is a CM of a CCP is not subject to a capital requirement if it is held in a manner with a custodian that is "bankruptcy remote" from the CCP. *See* 12 CFR __.35(b)(4).

- "Bankruptcy remote" means, "with respect to an entity or asset, that the entity or asset would be excluded from an insolvent entity's estate in receivership, insolvency, liquidation, or similar proceeding." *See* 12 CFR __.2.

On October 31, 2013, the FIA published an advisory paper on what would be needed to support a positive bankruptcy remoteness analysis with respect to collateral posted by a CM to a CCP.

Risk Management and Capital Treatment – US Bankruptcy Remoteness of IM

Per the advisory paper, the market has grown comfortable with the view that initial margin posted to by a CM to a CCP can be considered "bankruptcy remote" if it is subject to arrangements that would prevent it from being subject to:

- the competing claims of general creditors of the CCP or
- loss due to the CCP's default, including insolvency (e.g., as a result of re-use, repledge, rehypothecation or other transfer rights),

such that, in either case, the margin or its liquidation value would be unavailable for return to the CM in the CCP's insolvency.

Generally, the arrangements should ensure that a CM is not merely a general unsecured creditor of the CCP with respect to the return of its margin.

Risk Management and Capital Treatment – US Bankruptcy Remoteness of IM

- This would usually require, among other things, that:
  - legally, the CCP only has a security interest in, rather than ownership of, the initial margin;
  - the initial margin is held in a manner that ensures it would not constitute property of the CCP (generally requiring, among other things, that the initial margin is identifiable and is not commingled with the proprietary assets of the CCP);
  - the CCP cannot use initial margin in a way that would impair a CM's right to the return of the margin or its liquidated value (e.g., limits on use and/or proceeds of any use are likewise identifiable and not commingled with the proprietary assets of the CCP).
- Implicitly, the CCP's insolvency regime should also recognize/respect its limited interest in the initial margin.
- The advisory paper takes the view that the ratable distribution of liquidation margin to CMs in priority to general creditor claims, as under Part 190, can be consistent with "bankruptcy remote."

Risk Management and Capital Treatment – US Risk Weights of Cleared Transactions

For a cleared transaction with a qualifying central counterparty (**QCCP**), a clearing member client must apply a risk weight of:

- 2 percent if:
  - the collateral posted to the QCCP or clearing member is subject to an arrangement that prevents any losses to the clearing member client due to the joint default or a concurrent insolvency, liquidation, or receivership proceeding of the clearing member and any other clearing member clients of the clearing member; and
  - the clearing member client has conducted sufficient legal review to conclude with a well-founded basis (and maintains sufficient written documentation of that legal review) that in the event of a legal challenge (including one resulting from an event of default or from liquidation, insolvency, or receivership proceedings) the relevant court and administrative authorities would find the arrangements to be legal, valid, binding and enforceable under the law of the relevant jurisdictions.

  § _.35(b)(3)(A).
- 4 percent if the requirements of § __.35(b)(3)(A) are not met.

Implicitly, questions of treatment in a QCCP insolvency raise Part 190.

For a cleared transaction with a CCP that is not a QCCP, a clearing member client must apply the risk weight appropriate for the CCP according to subpart D of 12 CFR Part 3, 217 or 324.

Risk Management and Capital Treatment – US Risk Weights of Cleared Transactions

A QCCP means, generally, a CCP that:

- Is a FMU that has been designated as systemically important under Title VIII of the Dodd-Frank Act;
- If not located in the United States, is regulated and supervised in a manner equivalent to a designated FMU; or
- Meets the following standards:
  - The CCP requires all parties to contracts cleared by the counterparty to be fully collateralized on a daily basis;
  - The banking organization's primary federal regulator concludes that the CCP:
    - Is in sound financial condition;
    - Is subject to supervision by the Board, the CFTC, or the Securities Exchange Commission (SEC), or, if the central counterparty is not located in the United States, is subject to effective oversight by a national supervisory authority in its home country; and
    - Meets or exceeds the risk-management standards for central counterparties set forth in regulations established by the Board, the CFTC, or the SEC under Title VII or Title VIII of the Dodd-Frank Act; or if the central counterparty is not located in the United States, meets or exceeds similar risk-management standards established under the law of its home country that are consistent with international standards for central counterparty risk management as established by the relevant standard setting body of the Bank of International Settlements.

And provides/makes available its hypothetical capital requirement or the information necessary to calculate such hypothetical capital requirement.

§ __.2.

Risk Management and Capital Treatment – EU Capital Requirements Regulation

- Article 305(2) of the Capital Requirements Regulation (**CRR**) allows an institution to calculate its own funds requirements for its trade exposures for CCP-related transactions with its CM in accordance with Article 306 if certain conditions are met.
- The conditions are:
  - 305(2)(a): *the positions and assets of that institution related to those transactions are distinguished and segregated, at the level of both the clearing member and the CCP, from the positions and assets of both the clearing member and the other clients of that clearing member and as a result of that distinction and segregation those positions and assets are bankruptcy remote in the event of the default or insolvency of the clearing member or one or more of its other clients*

Risk Management and Capital Treatment – EU Capital Requirements Regulation

- 305(2)(b): *laws, regulations, rules and contractual arrangements applicable to or binding that institution or the CCP facilitate the transfer of the client's positions relating to those contracts and transactions and of the corresponding collateral to another clearing member within the applicable margin period of risk in the event of default or insolvency of the original clearing member. In such circumstance, the client's positions and the collateral shall be transferred at market value unless the client requests to close out the position at market value*
- 305(2)(c): *the institution has available an independent, written and reasoned legal opinion that concludes that, in the event of legal challenge, the relevant courts and administrative authorities would find that the client would bear no losses on account of the insolvency of its clearing member or of any of its clearing member's clients under the laws of the jurisdiction of the institution, its clearing member and the CCP, the law governing the transactions and contracts the institution clears through the CCP, the law governing the collateral, and the law governing any contract or agreement necessary to meet the condition in point (b)*
- 305(2)(d): *the CCP is a QCCP*

Risk Management and Capital Treatment – EU Capital Requirements Regulation

- Of the four requirements, only 305(2)(c) expressly requires a formal legal opinion.
- At the end of June 2021, CRR is expected to be amended such that this requirement will be replaced with a requirement that:
  - *the client has conducted a sufficiently thorough legal review, which it has kept up to date, that substantiates that the arrangements that ensure that the condition set out in point (b) is met are legal, valid, binding and enforceable under the relevant laws of the relevant jurisdiction or jurisdictions*
- In other words, the emphasis will shift from loss to the conditions by which positions and collateral will be ported, or transferred, to a solvent CM.
- While the amendment removes formal legal opinion requirements that made it more difficult to use capital relief, it remains to be seen what degree of external legal review will get institutions comfortable.
- In either case, from a U.S. perspective Part 190 is key to the consideration of either issue.

CCP Resilience Recovery and Resolution

- Bankruptcy unlikely to be best means of addressing CCP impairment
- Enforceability of “end of the waterfall” tools against the CCP
- Enforceability of “end of the waterfall” tools against CM
- Enforceability of default rules against CCP
- Enforceability of default rules against CM
- Enforceability of asset segregation – Guarantee Fund Contribution
- Porting
- No creditor worse off

Proposed Part 190 - Overview

A Subchapter IV proceeding is a special form of Chapter 7 liquidation proceeding with many of the standard features that such a proceeding entails, including:

- appointment of a trustee to administer the debtor's estate;
- the supervision of a bankruptcy court;
- the application of the automatic stay and the other general provisions of the Bankruptcy Code.

Entities that are both commodity brokers and broker-dealers that are members of the Securities Investors Protection Corporation are also subject to proceedings under the Securities Investors Protection Act (**SIPA**).

- The practice has been that the commodity broker piece is governed by Subchapter IV and Part 190 and the broker-dealer piece is governed by SIPA.
- Proposed Part 190.00(d)(1)(ii) makes this more clear by providing that a trustee of such a joint broker would have the same duties as a trustee in a proceeding under subchapter IV to the extent consistent with SIPA.
- Proposed Part 190.09(a)(1)(ii)(L) deals with customer property issues in the case of a proceeding under SIPA.

Part 190 contains the bulk of the operative provisions that would apply in the U.S. bankruptcy of a FCM or DCO.

Part 190 - Customers

Part 190 prioritize "customers" of a commodity broker, who have priority with respect to "customer property" over general creditors of the Commodity Broker.

- With respect to an FCM, a "customer" is generally an entity that holds a claim against the FCM on account of a commodity contract made, received, acquired, or held by or through the FCM in the ordinary course of the FCM's business as an FCM from or for such entity's commodity contract account (or deposit of property for making or margining, or making or taking of delivery on, such a commodity contract).
- With respect to a DCO, a "customer" is a clearing member that holds a claim against the DCO on account of cash, a security, or other property received by the DCO to margin, guarantee, or secure a commodity contract in the clearing member's proprietary or customers' account.

Part 190 also prioritizes "public customers" over "non-public customers."

- "Non-public" customers would generally describe the commodity broker itself and certain insiders and affiliates (i.e., "any person enumerated in the definition of Proprietary Account in 17 CFR § 1.3 or § 31.4(e), any person excluded from the definition of "foreign futures or foreign options customer" in the proviso to 17 CFR 30.1(c), or any person enumerated in the definition of Cleared Swaps Proprietary Account in 17 CFR § 22.1).
- "Public" customers are defined simply as customers that are not "non-public" customers.

The scope of "customer property" is set forth in current Part 190.08 and proposed Part 190.09. Proposed Part 190.09(a)(1)(ii)(L), like current Part 190.08(a)(1)(ii)(L), includes other assets in the debtor's estate to the extent preceding items in the list are not sufficient to satisfy all public customer claims. This includes, if the debtor is subject to SIPA, any excess securities-side "customer property" that remains after allocation under SIPA (such excess would normally go to the general estate).

Part 190 - Customers

Proposed Part 190 maintains the same general principles with respect to the relative priorities of customers vs non-customers and public vs non-public customers.

However, as to FCMs, it inverts the way "public" and "non-public" customers are defined under current Part 190 by (i) detailing what a "public" customer is and (ii) providing that a "non-public" customer is any customer that is not a "public" customer.

With respect to an FCM, a "public" customer will be, in relation to:

- (i) the futures account class, a futures customer as defined in 17 CFR 1.3 whose futures account is subject to the segregation requirements of section 4d(a) of the Commodity Exchange Act and CFTC regulations thereunder, including as applicable 17 CFR §§ 1.20-1.30;
- (ii) the foreign futures account class, a § 30.7 customer as defined in 17 CFR § 30.1 of whose foreign futures accounts is subject to the segregation requirements of 17 CFR § 30.7;
- (iii) the cleared swaps account class, a Cleared Swaps Customer as defined in 17 CFR § 22.1 whose cleared swaps account is subject to the segregation requirements of 17 CFR Part 22; [and]
- (iv) the delivery account class, a customer that is or would be classified as a public customer if the property reflected in the customer's delivery account had been held in an account described in paragraphs (1)(i), (ii) or (iii).

A "non-public" customer would be any customer that is not a "public" customer.

The CFTC notes that this change could impose costs on any customers, if they exist, that could be "public" under current Part 190 and "non-public" under proposed Part 190 (as current Part 190 defines a "public" customer with much less specificity that proposed Part 190).

As discussed later, for DCOs there are separate definitions of "public" and "non-public" customers.

Part 190 – Account Classes

Part 190 separates customer claims and property into "account classes" generally defined by the types of commodity contracts therein.

The CFTC has the authority to create/define account classes.

Current Part 190 classes of accounts are futures accounts, foreign futures accounts, leverage accounts, delivery accounts, and cleared swaps accounts.

Proposed Part 190:

- Eliminates the leverage accounts class and split the delivery accounts class into separate physical and cash delivery account classes to allow for more prompt distribution of the former, on the rationale that cash delivery can be more difficult to trace.
- Provides that where positions and assets of that would belong to an account class are commingled with the commodity contracts in another account class, e.g., in portfolio margining and cross-margining situations, the trustee should treat everything as part of the second account class. This also applies to securities positions in a commodity account class and commodity contracts in a securities account. This is the "home field" rule. Proposed Part 190.01.

Part 190 – Loss Mutualization

"Customers" are entitled to the distribution of "customer property" on the basis of their allowed "net equity" claims, which are calculated in accordance with Part 190 based on, based on, among other things, the value of each customers' account.

"Net equity" claims within a given account class are entitled to the pro rata distribution of property in that account class, meaning that any shortfall in the property in a given account class will result in a proportionate loss to all customers within that account class relative to their allowed net equity claims.

Any customer property that would not be attributable to any particular account class or which is in excess of public customer net equity claims for the account class to which it is attributed, would be distributed to public customers in respect of net equity claims in other account classes where there is a shortfall. Consistent with proposed § 190.00(c)(3), non-public customers may not receive any distribution of customer property so long as there is any shortfall, in any account class, of customer property needed to satisfy public customer net equity claims.

Part 190 – Operation of the Estate

Part 190 generally contemplates that the trustee will use best efforts to transfer all open commodity contracts and related property to another FCM.

Any positions that are not transferred will be liquidated.

Current Part 190 contemplates that certain accounts may be held open for later transfer even after after the "primary liquidation date," being "the first business day immediately following the day on which all commodity contracts have been liquidated or transferred which are not being held open for later transfer." 17 CFR 190.01(gg).

Proposed Part 190 will remove this possibility by ensuring that all commodity contracts will be either transferred or liquidated prior to the primary liquidation date.

- The CFTC acknowledges that this change may adversely affect customers who might otherwise have benefited from having their open commodity contracts held open for transfer after the primary liquidation date. Liquidating more contracts may also have the effect of driving down prices.

Part 190 – Porting

Current and proposed Part 190 both express a clear policy preference for "porting," or the transfer of customer positions and assets to a solvent FCM rather than liquidation.

- The CFTC will now state this preference more explicitly in proposed Part 190.00(c)(4).
- Porting mitigates risks to both the customers of the debtor FCM and to the markets. Porting (rather than the alternative, liquidation) of customer positions protects customers' hedges from changes in value between the time they are liquidated and the time, if any, that the customer may be able to re-establish them.

Proposed Part 190 also contains a number of changes which create greater flexibility for the trustee than to significantly alter existing practice.

> Under current Part 190, the trustee has a duty to "immediately" use "best efforts" to effect a transfer of customer open commodity contracts and equity by no later than the seventh calendar day after the entry of the order for relief. 17 CFR 190.02(e)(1). Under proposed Part 190, the trustee will have a duty to "promptly" do so.

Part 190 – Porting

Under current Part 190, the trustee must provide notice of its intent to transfer or apply to transfer no later than the close of business on the third calendar day after the order for relief. 17 CFR 190.02(a)(2).

Under proposed Part 190, the trustee must instead provide such notice as soon as possible. Proposed Part 190.03(b)(2).

- The CFTC's view is that three days is generally too long, and its expectation is that the trustee would begin working on a transfer as soon as it is appointed and that, by the end of three days, such transfers will likely be completed, actively in process, or determined not to be possible.
- Nevertheless, it also acknowledges that a specific deadline for notification could be harmful in circumstances where three days is too short, e.g., by implying that an intent to transfer cannot be formed after such time.

The CFTC adopted these measures in recognition of the difficulty in treating large numbers of customers on a bespoke basis. These changes represent a move from a model where the trustee receives/complies with instructions from individual customers to a model – reflecting actual practice in commodity broker bankruptcies in recent decades – where the trustee transfers as many open commodity contracts as possible.

Part 190 – Porting

Under current Part 190, the amount of property that may be transferred may not exceed the "funded balance" of the account based on available information as the calendar day immediately preceding transfer, less the value of property previously returned or transferred. 17 CFR 190.06(e)(2).

- In light of the CFTC's preference for prompt action, calculations of each customer's funded balance are directed in proposed § 190.05 to be "as accurate as reasonably practicable under the circumstances, including the reliability and availability of information." This would allow the trustee to avoid more precise calculations where such precision would not be cost effective or could not reasonably be accomplished on a prompt basis (for example, in a situation where price information for particular assets or contracts at particular times was not readily available).

Under proposed Part 190, the trustee may not make a transfer if, after taking into account all customer property available for distribution to customers in the applicable account class, such transfer would result in in insufficient remaining customer property to make an equivalent percentage distribution to all customers in the applicable account class, based on (i) customer claims of record and (ii) estimates of other customer claims made in the trustee's reasonable discretion based on available information, in each case as of the calendar day immediately preceding transfer. Proposed Part 190.07(d)(5).

- While the overall policy of maintaining pro rata distribution remain the same, this change is intended to liberalize the requirements for porting to some degree, by, in the CFTC's words, "valuing cost effectiveness over precise values of entitlement." The CFTC expressly acknowledges that this change could adversely impact customers who might otherwise be entitled to a greater distribution under a more precise calculation.
- A partial transfer of contracts and property is permissible so long as such transfer would not increase the amount of any customer's net equity claim, i.e., which would break netting sets and make a customer worse off (Proposed Part 190.07(d)(2)(ii)).

Part 190 – Porting

Under current Part 190, no clearing organization may adopt, maintain in effect, or enforce rules which prevent the acceptance by its members of transfers of open commodity contracts and the equity margining or securing such contracts from debtor FCMs, if such transfers have been approved by the CFTC. 17 CFR 190.06(a)(3).

Under proposed Part 190, no clearing organization may adopt, maintain in effect, or enforce rules which interfere with, rather than prevent, the acceptance by its members of transfers of open commodity contracts and the equity margining or securing such contracts from debtor FCMs if such transfers have been approved by the CFTC. Proposed 190.07(a)(3).

- The provision also has a new proviso that the restriction does not limit a clearing organization's contractual right to adequately manage risk or to liquidate or transfer open commodity contracts.
- This change appears overall favorable to the position of porting.

DCO Insolvency - Overview

Current Part 190 applies to all "commodity brokers", including DCOs.

- However, no DCO has ever filed for bankruptcy – notwithstanding MF Global and Peregrine Financial, even FCM insolvency has been quite rare.
- Current Part 190 is light on DCO-specific provisions and doesn't comprehensively to address all of the issues that would arise in a DCO insolvency.
- In the past, the CFTC has taken the view that a DCO bankruptcy would be *sui generis*.

As is noted by the ABA Part 190 Subcommittee

> "the likelihood of liquidating a DCO in a subchapter IV proceeding may be remote, so long as that is a possibility, we believe it is important for Part 190 to set out the basic rules that would apply. In the event that a DCO is instead subject to an orderly liquidation proceeding by the FDIC pursuant to Title II of the Dodd-Frank Act, the [Rules] could provide useful guidance on distribution of customer and member property in accordance with subchapter IV of chapter 7 of the Code, and consistent with no-creditor worse off standards."

And as the CFTC observes, noting that a DCO might be subject to OLA:

- The maximum liability of the FDIC, acting as a receiver for a covered financial company in an OLA resolution under Title II, is the amount the claimant would have received if the FDIC had not been appointed receiver and the covered financial company had instead been liquidated under chapter 7 of the Bankruptcy Code. Thus, in developing resolution strategies for a DCO while mitigating claims against the FDIC as receiver, *it is important to understand what would happen if the DCO was instead liquidated pursuant to chapter 7 of the Bankruptcy Code (and this part 190), and such a liquidation is the counterfactual to resolution of that DCO under Title II.*
- Proposed Part 190.00(d)(iii) states that it is intended to provide guidance for the distribution of customer and member property if OLA applies.

Subpart C of Proposed Part 190 therefore introduces, for the first time, detailed rules to govern DCO bankruptcies.

A general theme of Subpart C is deference/use of the DCO's existing rules and procedures.

DCO Insolvency – Subchapter IV

Subchapter IV establishes foundation principles for a DCO bankruptcy:

- 11 USC 761(9)(D): "Customer" means, "with respect to a clearing organization, clearing member of such clearing organization with whom such clearing organization deals and that holds a claim against such clearing organization on account of cash, a security, or other property received by such clearing organization to margin, guarantee, or secure a commodity contract in such clearing member's proprietary account or customers' account." 11 USC 761(9)(D).
- 11 USC 761(16): "Member property" means "customer property received, acquired, or held by or for the account of a debtor that is a clearing organization, from or for the proprietary account of a customer that is a clearing member of the debtor."
- 11 USC 763(b): A member of a clearing organization shall be deemed to hold such member's proprietary account in a separate capacity from such member's customers' account.
- 11 USC 766(d): The trustee shall distribute:
  - customer property, other than member property, ratably to customers on the basis and to the extent of such customers' allowed net equity claims based on such customers' accounts other than proprietary accounts, and in priority to all other claims, except claims of a kind specified in section 507(a)(2) of this title that are attributable to the administration of such customer property; and
  - member property ratably to customers on the basis and to the extent of such customers' allowed net equity claims based on such customers' proprietary accounts, and in priority to all other claims, except claims of a kind specified in section 507(a)(2) of this title that are attributable to the administration of member property or customer property.

DCO Insolvency – Current Part 190

Current Part 190 has few provisions dealing specifically with DCOs:

- 17 CFR 190.06(f): "Commodity contracts held by a clearing organization which is a debtor may not be transferred."
- 17 CFR 190.09
  - "Member property" means "in connection with a clearing organization bankruptcy, the property which may be used to pay that portion of the net equity claim of a member which is based on its house a
  - Member property shall include all money, securities and property received, acquired, or held by a clearing organization to margin, guarantee or secure, on behalf of a clearing member, the proprietary account, as defined in § 1.3 of this chapter, any account not belonging to a foreign futures or foreign options customer pursuant to the proviso in § 30.1(c) of this chapter, and any Cleared Swaps Proprietary Account, as defined in § 22.1 of this chapter: *Provided*, *however*, that any guaranty deposit or similar payment or deposit made by such member and any capital stock, or membership of such member in the clearing organization shall also be included in member property after payment in full, in each case in accordance with the by-laws or rules of the clearing organization, of that portion of:

    (1) The net equity claim of the member based on its customer account; and

    (2) Any obligations due to the clearing organization which may be paid therefrom, including any obligations due from the clearing organization to the customers of other members.

DCO Insolvency – Proposed Part 190 – Customers

Proposed Part 190.01 still defers to Subchapter IV to define what a "customer" is for a DCO.

However, Part 190.01 now expressly distinguishes between "public" customers and "non-public" customers of a DCO:

- A "non-public" customer of a DCO means any person whose account carried on the books and records of:
  - (i) a member of the clearing organization that is a futures commission merchant, is classified as a proprietary account under 17 CFR § 1.3 (in the case of the futures or foreign futures account class) or as a cleared swaps proprietary account under 17 CFR § 22.1 (in the case of the cleared swaps account class), or
  - (ii) a member of the clearing organization that is a foreign broker, is classified or treated as proprietary under and for purposes of (A) the rules of the clearing organization or (B) the jurisdiction of incorporation of such member.
- A "public" customer of a DCO is any customer that is not a "non-public" customer.

This reflects that a clearing member may have claims against a DCO in separate capacities: (i) for "public" customers (customer accounts) and (ii) for "non-public" customers (house accounts).

DCO Insolvency – Proposed Part 190 – Porting

Proposed Part 190.13 provides that the following transfers cannot be avoided:

- Proposed Part 190.13(a): any transfer of open commodity contracts and the property margining or securing such contracts made to another DCO that was approved by the CFTC, made prior to the entry of the order for relief.
- Proposed Part 190.13(b): any transfer of open commodity contracts and the property margining or securing such contracts made to another DCO that was made with the approval of the CFTC, on or before the seventh calendar day after the entry of the order for relief.

The CFTC states in the preamble that explicit CFTC approval is required for DCO transfers.

Proposed Part 190 does not appear to impose the same "best efforts" duty for a DCO trustee to attempt a transfer as it does for an FCM trustee.

Thus, unlike current Part 190, porting is at least possible under proposed Part 190.

DCO Insolvency – Proposed Part 190 – Continued Operation

Proposed Part 190.14(b) provides that after the order for relief, the DCO shall cease making calls for variation or initial margin. However, the trustee may request CFTC permission to continue operation for up to six calendar days if the trustee believes that continued operation of the DCO on a temporary basis would:

- facilitate either (A) prompt transfer of the clearing operations or (B) resolution under OLA, and
- be practicable, in the sense that (A) the DCO rules do not compel termination under those circumstances and (B) all or substantially all clearing members would be able to, and would in fact, make variation payments during the temporary timeframep Part 190.13(a): any transfer of open commodity contracts and the property margining or securing such contracts made

The CFTC may grant the trustee fewer calendar days than requested but has the discretion to renew (so long as continued operation does not exceed six calendar days).

Under current Part 190, it would not be possible to continue the operations of a debtor DCO for any amount of time after entry of the order for relief, as there is no clear and coherent mechanism to do so. Providing such a mechanism to enable the trustee to continue the operations of the debtor clearing organization for a set amount of time could, in certain circumstances, benefit clearing members and their customers as well as markets and the broader financial system by allowing time to accomplish an impending transfer of the debtor's clearing operations.

Proposed Part 190.14(c) provides that the trustee shall shall liquidate all open commodity contracts that have not been terminated, liquidated or transferred no later than seven calendar days after entry of the order for relief, unless the CFTC determines that liquidation would be inconsistent with the avoidance of systemic risk or would not be in the best interests of the debtor's estate. Such liquidation shall be conducted in accordance with the rules and procedures of the DCO to the extent applicable and practicable.

DCO Insolvency – Proposed Part 190 – Deference to Default Rules and Wind-down Plans

Proposed Part 190.15 requires a trustee to generally defer to a DCO's existing default rules, procedures, and recovery and wind-down plans in numerous respects, which will have been developed pursuant to Part 39 of the CFTC's rules.

- The CFTC observes that "this approach relieves the trustee of the burden of developing, in the moment, models to address an extraordinarily complex situation."

Specifically, the trustee:

- shall not avoid or prohibit any action taken by a DCO subject to this subpart that was reasonably within the scope of and was provided for in any recovery and wind-down plans maintained by the debtor and filed with the CFTC (Proposed 190.15(a));
- implement, in consultation with the CFTC, the DCO's existing default rules and procedures maintained in accordance with other CFTC rules, including any termination, close-out and liquidation provisions, subject to the reasonable discretion of the trustee and to the extent such implementation is practicable (Proposed 190.15(b)); and
- in consultation with the CFTC, take actions in accordance with any recovery and wind-down plans maintained by a DCO and filed with the CFTC to the extent reasonable and practicable (Proposed 190.15(c)).

This approach also ensures that "resources that are intended to flow through to members as part of daily settlement (including both daily variation payments and default resources) should be devoted to that purpose, rather than to the general estate."

Thus, in evaluating the risks (including capital consequences) faced by clearing members, there will need to be greater focus on a DCO's default rules, procedures, and recovery and wind-down plans. This resembles the typical focus of the analysis for European CCPs.

DCO Insolvency – Proposed Part 190 – Customers and Net Equity

Proposed Part 190.17 provides that a clearing member that trades on a DCO through both a customer account for public customers and a house account will be treated as having customer claims in separate capacities. Proposed 190.17(a)(1). Net equity would be calculated separately for each separate customer capacity and, as would be expected, for each separate account class. Proposed 190.17(a)(2).

- Claims relating to the customer account will be treated as "public customer claims" and claims relating to the house account will be treated as "non-public customer claims." Proposed 190.17(a)(1).
- The calculation of a clearing member's net equity claim shall include the full application of a DCO's loss allocation rules and procedures, including, with respect to a claim arising out of a house account, any assessments or similar loss allocation arrangements under such rules. Proposed 190.17(b)(1).
  - The CFTC acknowledges that this provision could impose costs on clearing members whose net equity claims may have been greater absent the application of the clearing organization's loss allocation rules and procedures.
- Adjustments may be made to a clearing member's net equity claim if a DCO's loss allocation rules and procedures would entitle clearing members to additional payments of cash or other property due to (a) unused mutualized default resources that are prefunded or assessed and collected or to (b) a DCO's recoveries on claims against others, including recoveries on claims against defaulted clearing members (Proposed 190.17(b)(2)).
- General principles concerning calculation of net equity would still apply (Proposed 190.17(c)).

DCO Insolvency – Proposed Part 190 – Allocation of Customer Property

Proposed Part 190.18 provides that the customer property of a DCO's estate must be allocated between (i) member property and (ii) customer property other than member property. Again, such allocation would continue to be by account class.

- Proposed Part 190.18(b)(1)(ii) makes explicit what is currently implied by current Part 190.09 - that customer property includes any guarantee fund deposit, assessment, or similar payment or deposit, to the extent any remains following administration of a DCO's default rules and procedures, constitutes customer property. Such assets would be allocated first to customer property other than member property, i.e., to benefit public customers, and then to member property.
- Proposed Part 190.18(c)(2) and (c)(3) would allocate any excess funds in any account class for house or customer accounts first to customer property other than member property, i.e., to apply to "public customer claims," and then to member property, i.e., to apply to "non-public customer claims."
- If, prior to bankruptcy, a DCO kept initial margin for house accounts in accounts without separation by account class, then member property will be considered to be in a single account class. Proposed 190.18(e).

DCO Insolvency – Proposed Part 190 – Summary

While proposed Part 190 creates, for the first time, clear and detailed rules for the treatment of clearing member customer and house accounts in a DCO bankruptcy parties, would need to consider (i) the clear guidance that the bankruptcy trustee is to defer to the existing default rules, procedures, and recovery and wind-down plans of a DCO and (ii) the impact, if any, on their capital analysis where public customers may have priority to certain assets in the customer property pool (including excess assets from a house account in any given account class).