CME Group | Advisory Notice

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DATE: February 7, 2013

TO: Clearing Member Firms

FROM: CME Clearing

SUBJECT: **CME's Updated LSOC Phase 2 Schedule and Principles**

Introduction

This advisory provides updated information on CME's implementation schedule for LSOC phase 2, often called "LSOC with excess", "LSOC with client-specific value reporting", or "LSOC with client-specific excess."

LSOC, which is short for Legally Segregated Operationally Commingled, is a new CFTC regulatory regime which took effect on Wednesday November 14, 2012. LSOC applies to positions and collateral for customer cleared swaps. It does **not** apply to futures unless such futures clear in the customer cleared swaps origin pursuant to DCO rules for portfolio margining of futures versus swaps.

LSOC was implemented last year by the industry in a mode called "**no excess**" or **"unallocated client excess"**. In this mode, any collateral value deposited by the FCM with the CCP in excess of the aggregate client minimum initial margin requirement, to the extent it has not been explicitly identified by the FCM as being provided by the firm, is treated as **unallocated client value**. Since it is client value but its ownership has not been identified, it cannot be used by the CCP for any purpose, and in the event of an FCM default would be returned to the bankruptcy trustee for the benefit of clients.

The industry is now working to offer clients and FCM's **LSOC phase 2 – "LSOC with excess", also known as LSOC with client-specific value reporting.** In this mode, FCM's must provide a report at least once per day to the CCP, providing an ownership breakdown of the value of collateral deposited by the FCM with that CCP in the customer cleared swaps origin. Collateral value may be identified as: (a) belonging to a specific customer; (b) provided by the firm (the "firm contributed value", sometimes called "firm contributed assets" or "residual value"); or (c) unallocated client value.

The differences between the two modes could be summarized as follows:

- In the unallocated excess mode, the value attributed to each client is equal to the client's minimum margin requirement, whereas in the client-specific excess mode, the value attributed to each client is the exact value reported by the FCM.

- In the unallocated excess mode, no daily reporting from the FCM is required, whereas in the client-specific excess mode, the FCM must report each client's value at least once per business day.

Note that LSOC does not **mandate** that FCM's deposit client excess collateral value with CME or any CCP.

CME's updated LSOC phase 2 implementation schedule

CME Clearing will <u>begin</u> allowing firms to operate in LSOC phase 2 mode – LSOC with daily client-specific collateral value reporting – on Monday, April 22, 2013.

There is no **requirement** that firms begin operating in LSOC with excess mode on that date, and we anticipate a transition process occurring over a period of several months, as firms test and go live with LSOC phase 2. **CME has not established a date by which firms must convert**, and may allow firms to continue operating in LSOC phase 1 mode indefinitely.

Firms may begin **testing** their submissions of daily collateral value reports at any time. We expect full-scale parallel testing to begin with a subset of firms around March 1.

Principles of LSOC Collateral Value Reporting at CME

You can think of LSOC collateral value reporting like this: the FCM has deposited a pool of collateral assets (cash and securities) at a CCP to cover initial margin requirements for customer cleared swap positions for a specific **settlement account** at that CCP. For example, at CME Clearing, an FCM might have three such customer cleared swaps settlement accounts – one for interest-rate swaps, one for credit-default swaps, and one for FX and other swaps. For the assets deposited into each such settlement account, we can calculate the **total haircutted market value**.

The LSOC collateral value report provided by the clearing firm to the CCP, contains a breakdown of that total haircutted market value of the assets deposited for that settlement account. The breakdown is provided as follows:

- Value provided by specific clients
- Value provided by the firm (firm-contributed value)
- Unallocated client value

CME has established the following principles regarding the timing of collateral value reporting:

- The firm may submit **any number** of collateral value reports each day.

- The firm must report each client's collateral value **at least once** per clearing business day. The sole exception is US bank holidays, on which firms are encouraged but not required to report.

- Each collateral value report may be for **some** accounts or for **all** accounts – a "partial" report, or a "complete" report.

- Collateral value reports may be submitted **at any time**. The deadline for submitting collateral value reports to be taken into account in the end-of-day settlement cycle, will be **8:00pm Eastern time**. Files submitted after the deadline will be processed as of the next day.

CME has established the following principles for firms to use in determining the values reported:

- The key number being reported is the **total haircutted market value** attributed to that client, of the pool of such collateral on deposit at CME Clearing in that particular settlement account.

- Values may be reported either **currency by currency**, or in a single **currency-equivalent** (for example, USD-equivalent, or EUR-equivalent.)

- The firm may elect to use its own set of market prices and haircut percentages, provided that they are (a) reasonable, (b) an audit trail is maintained of the values used, and (c) for haircut percentages, that they are not unreasonably less conservative than CME Clearing's. There is no requirement that the firm use CME's own values for market prices or haircut percentages.

- Similarly, if the firm elects to report in currency-equivalent terms, the firm may use its own exchange rates, provided that they are reasonable and that an audit trail is maintained.

CME will use these principles in determining whether any particular collateral value report is valid, and hence whether it will be accepted or not:

- The total value reported as belonging to customers – the sum of specific customer values plus the unallocated client value – may not exceed CME's own valuation of the total haircutted market value of the collateral on deposit.

- The grand total reported – including the reported firm-contributed value – must be reasonably close to CME's own valuation of the collateral on deposit.

Optional methods and values for reporting

Reporting in terms of excess or deficit

If a firm wishes, it may elect to report the clients' value not in terms of **total haircutted market value**, but rather in terms of the client's **excess of value** or **deficiency in value**. If so, however, the firm must provide **both** that excess or deficit amount, and the FCM's evaluation of the client's minimum initial margin requirement for positions at CME.

This capability has been provided at the request of firms, but we encourage firms to report in the more simple and standard way – the total haircutted market value.

Reporting of the breakdown of value of an upcoming margin call

Reporting at any time must accurately reflect the breakdown of the value of collateral actually on deposit at CME. So for example, if the firm is reporting in the early hours of the morning, prior to the satisfaction of the morning margin call, the values reported must reflect client-specific values **prior to** the effect of that call.

If at the time of such a report, the firm knows the breakdown of that morning margin call – *ie,* which client is providing how much of the value, or how much value is being provided by the firm – it **may** elect to provide that additional information with the report. It is not required to do so, however, and a simpler method of achieving the same result would be simply to submit an updated collateral value report after the morning margin call has been met.

Optional values that may be reported

In addition to the **haircutted market value** of collateral attributable to each client, the firm may – but is not required to – also report the **unhaircutted market value** attributable to that client on deposit with CME.

Similarly, the firm may elect, but is not required, to provide **aggregate equity run data** about the value of the account at the firm – the ledger balance, open trade equity, option value, overall value of securities on deposit, and total initial margin requirement.

Although such reporting is not required at this time, it is encouraged, because in a default situation it will provide valuable information needed to manage the default and port positions and collateral value of non-defaulting customers to new FCM's in a timely manner.

Intraday collateral transactions

One use for intraday submissions of collateral value reports, is to facilitate intraday collateral transactions, and in particular withdrawals of excess collateral.

Under LSOC, unallocated client value can be withdrawn at any time, as can firm buffer – *ie,* firm-contributed value not needed to cover client-specific margin deficiencies.

So when a firm requests a withdrawal, to the extent that the haircutted market value of the asset to be withdrawn is covered by either unallocated client value or firm buffer, the withdrawal can be approved without the firm having to provide any additional information. But to the extent that the value to be withdrawn is **not** so covered, the firm must provide information as to which client's excess value is being withdrawn, and the withdrawal cannot be approved without this.

To avoid that processing step, a firm could submit an updated collateral value report immediately prior to requesting the withdrawal. In this report, it would reclassify the excess value to be withdrawn, from being value of the specific client, to being unallocated client value.

To be conservative when processing intraday collateral deposits and withdrawals in the absence of any data being provided: a deposit will always be treated as unallocated client value until otherwise specified. For withdrawals, to the extent that both unallocated client value and firm buffer exist, the withdrawal will be presumed to be coming from firm buffer first, before unallocated client value will be drawn down.

Specifications for Collateral Value Reports

Fully detailed specifications and examples for LSOC collateral value reporting are available at:
http://www.cmegroup.com/clearing/files/lsoc-cvr-fixml-examples.pdf

Other LSOC documentation

CME Clearing's primary web page for LSOC resources is at:
http://www.cmegroup.com/lsoc

Clearing Advisory 12-429 (published October 4, 2012) makes explicit exactly which products are covered by LSOC and which are not:
http://www.cmegroup.com/tools-information/lookups/advisories/clearing/files/Chadv12-429.pdf

Joint Audit Committee Advisory 12-03 (published October 18, 2012) provides details on how firms must do their "LSOC compliance calculation", verifying that they are not using the assets of one client to meet an obligation of another.
http://www.cmegroup.com/clearing/files/jac1203-lsoc-compliance-calculation.pdf