CME Group

LSOC and CME Group's Vision for Cleared Swaps Customer Protection

As a part of the Dodd-Frank Wall Street reform act, the CFTC published new regulations that provide for additional cleared swaps customer protection. Part 22 of the CFTC's regulations sets forth swaps customer protections standards, which are commonly referred to as "Legal Segregation with Operational Commingling, or "LSOC". LSOC provides a fundamental change in how FCM's and DCO's treat cleared swaps customer positions and related collateral. The protection that LSOC delivers for cleared swaps customers is incremental and does not solve for all risks associated with trading and clearing swaps. For example, in some scenarios non-defaulting customers of a defaulted FCM may be subject to pro rata distribution of assets per section 766.H of the U.S. Bankruptcy Code. The primary goals of LSOC are to reduce fellow customer risk and to protect cleared swaps customer collateral in the event that an FCM defaults to a DCO due to cleared swaps customer non-performance. CME Clearing, in addition to adhering to LSOC regulations, seeks to offer cleared swaps customers some added enhancements to provide more transparency, more control, and ultimately better protection.

EXECUTIVE SUMMARY

LSOC Fundamental Customer Protection Principle:

- A DCO may not use the collateral of one customer to pay for an obligation of another customer

FCM Defaults under LSOC

- CME's goals during an FCM default are:
  - Protect the interests of non-defaulting cleared swaps customers doing business with the defaulted FCM
  - Minimize impacts of the default amongst non-defaulted clearing firms
  - Quickly transfer the positions of non-defaulting cleared swaps customers to one or more transferee FCMs with as much collateral as possible

CME Enhanced Protections

- Under LSOC, should an FCM default to CME Clearing, CME plans to cease netting variation margin for cleared swaps customer accounts that comply with registration rules. This approach should enhance protections available to solvent, non-defaulting customers.
- Pending regulatory approval: Pilot program - CME Asset Transparency Account
  - CME plans to offer approved client accounts the ability to obtain greater transparency into the location of their collateral.
- Pending regulatory approval: Pilot Program - CME Safekeeping Account
  - CME plans to offer a custodial-based asset management program to approved clients.
- Pending Regulatory approval: Guaranteed Clearing Participant
  - CME plans to offer client a form of enhanced, individual account protection.

LSOC FURTHER EXPLAINED

On February 7, 2012, the CFTC published final regulations that impose new requirements on futures commission merchants (FCM's) and derivatives clearing organizations (DCO's) regarding the treatment of cleared swaps customer positions and related collateral[1]. These requirements, which can be found in Part 22 of the CFTC's regulations[2], are commonly referred to as Legal Segregation with Operational Commingling, or "LSOC". CME Clearing will replace its Cleared OTC Customer Sequestered rules with LSOC rules on November 5, 2012, three business days in advance of the LSOC regulatory implementation deadline of November 8, 2012.

The goal of LSOC is to reduce "fellow customer risk" that might otherwise arise at a Clearing House if, upon the failure of a clearing member, the Clearing House was able to use the entire pool of the failed clearing member's cleared swaps customer collateral to cure a customer default without regard to the ownership of the collateral.[3] For a given FCM, fellow customer risk refers to the risk that an FCM will violate the law and use a non-defaulting customer's collateral on deposit with the FCM to cover the obligations of another customer or for its own benefit. Moreover, as will be more fully discussed below, LSOC "provides limited protection from operational and investment risk."[4] However, CME seeks to offer cleared swaps customers additional customer protection mechanisms and enhancements in order to augment or to provide alternatives to basic LSOC protections.

What is LSOC supposed to do?

Under LSOC, upon the default of a clearing member, the collateral of its cleared swaps customers must be unpooled, allocated to particular customers, and used only for the benefit of the customer to whom it has been allocated. The fundamental premise of LSOC is that a DCO may not use the collateral of one customer to pay for an obligation of another customer. The purpose of the CFTC's LSOC regulations "is to protect Cleared Swaps Customer Collateral in the event that an FCM defaults to a DCO due to" cleared swaps customer non-performance.[5] Additionally, it is important to assess the treatment that a DCO will accord to variation margin, after the default of an FCM. As more fully described below, and presuming that an FCM fails to perform to CME Clearing, CME Clearing plans to cease netting cleared swaps customer variation margin. Depending on the process employed by a DCO, discontinuing the netting of variation margin in these circumstances may enhance portability.

Protection needs LSOC does not address

LSOC should achieve an incremental improvement to customer protection, but it does not provide protection from all forms of risk. Investment risk, FCM malfeasance risk, collateral liquidation risk in a default, and certain forms of fellow customer risk are not eliminated. The rules of LSOC only explicitly protect the collateral value attributed to each customer as reported by FCM's to DCOs. Additionally, LSOC may increase the likelihood of liquidation for some customer portfolios. Market participants should be mindful that under LSOC, while cleared swaps customer collateral is considered legally segregated, it is also operationally commingled, or "pooled". Similar to the case with customer futures collateral, an FCM will have to conduct financial compliance exercises to ensure that its obligations due to cleared swaps customers are met by sufficient assets on deposit at appropriate locations; i.e., the FCM must continually be in "seg compliance" for purposes of LSOC. If, at the time of a default of an FCM, the FCM is "under seg" in the cleared swaps customer account class, then section 766(h) of Chapter 7 of the US Bankruptcy Code would require that all cleared swaps customers of the FCM share any losses on a pro rata basis.

Another form of fellow customer risk present under LSOC concerns the circumstances under which a DCO chooses to net cleared swaps customer variation margin after an FCM default. Every cleared swaps customer of the defaulted FCM is at risk of not receiving variation gains due to fellow customer risk. Consequently, a DCO that is netting variation margin creates a pooled risk among fellow cleared swaps customers. If a DCO nets variation margin, it may create a shortfall of collateral owed to cleared swaps customers of the defaulting FCM. Since cleared swaps customer variation margin gains will be netted by the DCO against cleared swaps customer

[1] 77 Fed. Reg. 6336 (Feb. 7. 2012).

[2] 17 C.F.R. §§22.1, et seq.

[3] 77 Fed. Reg. 6338.

[4] Id, n. 13.

[5] Id.

variation margin losses, cleared swaps customers with variation gains are not assured of the extent to which these variation margin gains will be paid. The reduction in collateral will make it more difficult for DCOs to find a solvent FCM for customers to transfer to, or "port", in a default. These risks presented by a "netting DCO" impact the cleared swaps customers of the defaulted FCM at all DCOs. To help address this form of fellow customer risk, CME has chosen to use a "no variation margin netting post default" model. In this model, CME will work to collect margin obligations from clients of a defaulted FCM directly and credit those customers to which variation gains are owed.

CME Implementation of LSOC; Day-to-Day Procedures

Much of the change under the LSOC model involves information reporting between DCO's and FCM clearing members. On a daily basis, CFTC Regulation 22.11 requires that FCM clearing members provide DCO's a Portfolio of Rights and Obligations Report ("PRO").[6] Essentially, the PRO will show the value of each customer's collateral associated with the clearing level initial margin requirement for the customer's cleared swaps portfolio, as cleared by the customer's FCM. For CME cleared swaps product offerings, reports generated by CME Clearing will satisfy the basic Regulation 22.11 PRO requirement. However, CFTC Regulation 22.13 provides that if the rules of a DCO permit an FCM to transmit collateral in excess of the amount required by the DCO, then the DCO must provide a mechanism for the FCM to identify the amount of collateral posted for each customer in excess of that cleared swaps customer's margin requirement. CME Clearing intends to accept excess cleared swaps customer collateral, and will require FCM's to submit a daily Collateral Value Report ("CVR") for this purpose. The CVR will specify the value of each individual cleared swap customer's total collateral on deposit with the DCO.[7]

Each cleared swaps customer's collateral excess is calculated by comparing the cleared swaps customer's total collateral on deposit with the margin requirement for the cleared swaps customer's portfolio[8]. The CVR given to the DCO's on behalf of customers identifies, for each customer, the amount of collateral protected from being used to meet the obligation of another customer. FCM's may also maintain their own collateral in segregation, and will report these amounts to the DCO via the CVR as "Firm Contributed Value", which can be used by the DCO as an operational "cushion" relative to cleared swaps customer accounts if they issue a margin call.

Starting November 5, 2012, at the completion of a settlement cycle, CME Clearing will identify which, if any, of the FCM's cleared swaps customer accounts have an initial margin requirement in excess of the most recently reported collateral value. CME will then issue a margin call to cover the amount by which the sum of all of customer-specific initial margin deficiencies exceeds the firm contributed value. This provides certainty that each customer's margin requirement is met only by value provided either by that customer or by the firm. After the initial margin call is met, FCMs will have the option to request the withdrawal of all or part of cleared swaps customer collateral for which collateral value was in excess of margin required. The standard settlement bank confirmation deadline will not be changed from its current time of 8:30am Eastern.

CME Customer Protection Objectives if a Default Occurs

CME Clearing's primary customer protection goals under LSOC do not change. CME's goals are to protect the interests of non-defaulting cleared swaps customers doing business with the defaulted FCM, to minimize impacts of the default among non-defaulted clearing firms, and to quickly port the positions of non-defaulting cleared swaps customers to one or more transferee FCM's with as much collateral as possible, and to minimize overall market disruption.

Generally, in the event of an insolvency of an FCM clearing member, CME Clearing anticipates that it will work in conjunction with a court-appointed bankruptcy trustee or receiver. CME holds a minimum margin for each cleared swaps customer portfolio equal to

[6] With respect to foreign omnibus accounts, the CFTC's "intention is to continue to treat omnibus accounts of a foreign broker clearing through an FCM as a single 'customer' for purposes of the requirements of Part 22. However, to the extent a foreign broker is required to provide individual protection for swaps customer collateral under the laws of another jurisdiction, the [CFTC] intends that the regulations under Part 22 foster compliance with such laws." 77 Fed. Reg. 6358.

[7] Due to tight operational deadlines, on November 5, 2012, the first implementation of LSOC, DCOs will operate in Unallocated Customer Excess mode. This means that the LSOC protected collateral value specified for each customer will be their initial margin requirement, as calculated by the DCO. Any collateral value exceeding the aggregate customer pool initial margin requirement will be deemed unallocated customer excess. Beginning February 4, 2013, the second phase of implementation requires FCMs to identify to DCOs all customer-specific excess. FCMs must report customer specific excess to DCOs by no later than May 27, 2013. More details about the operational rollout can be found at http://www.cmegroup.com/tools-information/lookups/advisories/clearing/files/Chadv12-360.pdf

[8] Select futures products that are cross-margined against OTC products will be subject to LSOC rules. Customer cross-margining is pending regulatory approval.

five days of exposure. LSOC is intended to address the fellow customer risk that exists as a result of an FCM default. Under those circumstances, CME Clearing would expect to transfer, or "port" non-defaulting customers to solvent, non-defaulting FCMs by day of default plus two business days ("D+2"), subject to approval by the court, bankruptcy trustee or receiver and regulators, as necessary.

CME Treatment of Cleared Swaps Customers' Variation Margin after an FCM Default

If a clearing firm defaults to CME Clearing, then the value of cleared swaps customer collateral at CME Clearing attributed to any specific customer can be used only to cure losses or liabilities of that particular customer. Part 22 LSOC regulations protect the value of the collateral attributed to each cleared swaps customer, but they do not specify how DCO's treat variation gains and losses.

In an FCM default, CME Clearing's approach to variation margin will be to discontinue netting variation gains and losses within the defaulted FCM's cleared swaps customer account with CME Clearing on a post-default basis. CME Clearing will cease netting variation margin because we believe that taking this approach will result in the best outcome for customers and result in better protection from certain forms of fellow customer risk. By discontinuing VM netting, CME will better protect non-defaulting customers by helping them keep their positions intact while porting them to another FCM with as much collateral as possible.

CME Relationship with Cleared Swaps Customers after an FCM Default

In seeking to suspend netting for cleared swaps customer variation margin on a post default basis, CME Clearing will aim to settle variation margin with individual cleared swaps customers directly. Customers with whom CME Clearing directly settles must preregister with CME Clearing. These customers will be operating during this post-default period, and prior to porting, without an FCM guarantee. Until they are ported to a different FCM, customers are directly responsible for meeting their obligations to CME Clearing and complying with CME financial criteria.

Registered cleared swaps customer accounts will be able to meet obligations due to CME Clearing in order to ensure that their positions are not liquidated should they fall below their initial margin requirement. Customers that owe CME Clearing variation margin will be required to fund their accounts; failure to meet variation margin obligations to CME Clearing may mean liquidation of the customer's cleared swaps portfolio. Customers that are owed variation margin from CME Clearing may be paid these amounts, though such payments are likely to be conditioned upon terms approved by the bankruptcy trustee or receiver, or the amounts may be credited to the customer by CME for porting purposes. The bankruptcy trustee or receiver's decisions may be impacted by the policies taken by all DCO's through which the defaulted FCM cleared.

In the case of an FCM default, cleared swaps customers of the defaulting FCM that do not register with CME Clearing to directly settle variation margin under the "no netting" approach may have their positions promptly liquidated. CME Clearing will need specific information on individual customer accounts of the defaulting FCM, provided through the registration process, in order to provide customer firms with benefits of netting. Any cleared swap customer which has not registered may be subject to post-default netting of variation margin, meaning that it might not receive all of their post-default variation gains, and may be more likely to have its portfolio liquidated.

It is important to note that the CFTC's Part 22 regulations afford CME Clearing the right to liquidate any or all positions of the cleared swaps customers in the event of an FCM default.[9] Additionally, CME Clearing maintains the right to liquidate all collateral in order to return the customer's share (or pro rata share) of the value of that collateral.

CME'S PROPOSED ALTERNATIVE CUSTOMER COLLATERAL PROTECTION MECHANISMS AND ENHANCEMENTS

All customers need to know the terms of protection afforded to them under different customer protection models. No protection model will fit the needs of all customers equally. While LSOC offers an incrementally improved regulatory baseline protection for all cleared swaps customers, CME seeks to offer additional innovative and effective customer protection solutions above and beyond

[9] Regulation 22.15 states, in relevant part: "Nothing contained herein shall be construed to limit, in any way, the right of a derivatives clearing organization or Collecting Futures Commission Merchant to liquidate any or all positions in a Cleared Swaps Customer Account in the event of default of a clearing member of Depositing Futures Commission Merchant."

LSOC. If modified relationships between end-customers, clearing members, and a CCP are permitted (as suggested in the Federal Register for the CFTC's Part 22 LSOC regulations), then CME will offer alternative models of customer protection. CME is committed to ensuring it has the safest possible customer protection arrangements. Where such alternatives are not available under the current regulatory regime, CME will provide enhancements to regulatory protections to ensure customers are able to select and access the best safeguards for collateral based on their unique needs.

CME has developed several programs to address the concerns its customers have raised in order to allow them to better manage their portfolios under the new regulatory regime. CME seeks to meet the needs of these customers by providing improved transparency into their margin deposits, additional control over the movement of their margin funds, and reduced pro rata distribution risk.

Pending regulatory approval: Pilot Program, CME Asset Transparency Account

Through the CME Asset Transparency Account program, customers will have access to greater transparency into their specific customer-owned collateral value. Customers, working with their FCM, can request CME Clearing to move their collateral, on deposit with CME Clearing, from the FCM's omnibus customer collateral account into an account referencing the specific customer. At the end of each day, CME will provide a report to the FCM and the customer, or the FCM's approved designee, reflecting the assets on deposit and the associated market value.

A CME Asset Transparency Account will only be established upon the FCM's approval in accordance with end customer requests. These accounts are not designed to have multiple daily money movements, so fees above a daily transaction cap may be imposed. Collateral managed through CME Asset Transparency Account will still be subject to pro rata distribution in a default.

Pending regulatory approval: Pilot Program, CME Safekeeping Accounts

Pursuant to the Federal Register adopting release for the CFTC's LSOC regulations, CME Safekeeping accounts will aim to modify a version of legacy CFTC Interpretation 10 accounts so that end-customers can meet their margin obligations at FCM's via third-party custodial accounts. CME Safekeeping accounts will allow end-customers to utilize custodial account arrangements and use assets held in those accounts to meet margin obligations. FCM's will be able to transfer or pledge account assets onward to a DCO. CME, an FCM, an end-customer, and a custodian bank will execute a quad-party custody arrangement to facilitate the CME Safekeeping account transactions. Customers must manage the attendant custodial costs.

Note that previous CFTC regulations allowed customers to meet their margin obligations at FCM's via third-party custodial accounts; however, FCM's could not pledge collateral onward to a DCO in the legacy Interpretation 10 account structure. The FCM's were required to use their own capital to meet DCO margin obligations on behalf of those customers.

Collateral in Safekeeping accounts will still be subject to pro rata distribution in a default.

Pending regulatory approval: Guaranteed Clearing Participant (GCP)

In an effort to provide customers with individual customer protection, CME Clearing is developing a Guaranteed Clearing Participant (GCP) program. The GCP approach is an arrangement that allows an individual customer (a Guaranteed Clearing Participant) to provide collateral directly to CME that is held in a third-party custodian account. A GCP customer's collateral is deemed property of that individual customer. Customers will put their collateral in an account at a custodian bank under the DCO's name. GCP accounts can only be arranged if the customer is "guaranteed" by their FCM. Collateral in GCP accounts will not be subject to pro rata distribution in a default.

The account will be governed by an agreement between a CME-approved bank, CME, a customer, and a guaranteeing FCM. As part of the arrangement, the guarantor FCM would have a secondary lien on the GCP's collateral in the GCP account. GCP accounts will also be subject to risk, financial, and operational requirements as determined by CME Clearing.

For any questions regarding LSOC, please send an email to: LSOC@cmegroup.com.

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