CFTC's Rulemaking on the Segregation of Cleared Swaps Customer Collateral: LSOC and Beyond

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Introduction

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") mandated segregation of customer collateral for both cleared and uncleared swaps. In implementing the segregation requirement with respect to cleared swaps, the Commodity Futures Trading Commission ("CFTC" or the "Commission") has had to balance the costs and benefits to customers, Derivatives Clearing Organizations ("DCOs"), Future Commission Merchants ("FCMs") and other stakeholders. After much deliberation, the Commission adopted final rules that make the Legal Segregation with Operational Commingling Model ("LSOC") the standard for the segregation of cleared swaps customers' collateral. Yet, in light of the MF Global crisis, the Commission continues to study and consider the issue. This article focuses on: (a) the deliberations that led the Commission to arrive at the LSOC model as the regulatory standard; (b) the characteristics of the LSOC model; and (c) the possible future enhancements to the segregation framework under consideration by the Commission, including the Guaranteed Clearing Participant Model ("GCP").

The Segregation Models Originally Considered by the Commission

Section 724(a) of Dodd-Frank amends section 4d of the Commodity Exchange Act ("CEA") to require that:

> [m]oney, securities, and property of a swaps customer … shall be separately accounted for and shall not be commingled with the funds of the futures commission merchant or be used to margin, secure, or guaranty any trades or contracts of any swaps customer or person other than the person for whom the same are held.[1/]

Thus, Congress mandated: (a) the differentiation of individual cleared swaps customers' funds in FCM's books and records; (b) the physical segregation of these customers' funds from other monies;[2/] and (c) the prohibition of the use of the funds of one swaps customer to meet the obligations of another. The Commission began its implementation of these statutory requirements, with a roundtable on October 22, 2010 to discuss the most appropriate model for segregating customer funds. The roundtable revealed divergent viewpoints between buy-side market participants and supply-side FCMs, and DCOs.[3/]

After publishing an Advanced Notice of Proposed Rulemaking ("ANPRM"), and holding a second roundtable;[4/] on June 9, 2011, the Commission published a notice of proposed rule

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[1/] Dodd-Frank Act, Public Law 111-203, 124 Stat. 1376 (2010), § 724(a).

[2/] Amended section 4d does allow swaps customers' funds to be held in one account (i.e., "be commingled and deposited in the same account or accounts with any bank or trust company or with a derivatives clearing organization").

[3/] At this roundtable, stakeholders presented divergent positions. For the most part, customers argued that the goal of the segregation model should be to eliminate risks posed by a decline in FCMs' and DCOs' investments and the risky positions of fellow customers, while DCOs and FCMs largely argued that the operational costs of complete segregation measures could outweigh their benefits. *See* "Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions," 77 *Fed. Reg.* 6336, 6341 (February 7, 2012).

[4/] The ANPRM was published on December 2, 2010, and set out four possible models for customer segregation, all of which were included in the later NPRM. *See* "Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies," 75 *Fed. Reg.* 75162 (December 2, 2010). The second roundtable discussion revealed similarly divergent opinions as were aired at the first roundtable. 77 *Fed. Reg.* 6342.

making ("NPRM") requesting comment on the following four alternatives for segregation of cleared swaps customers' funds: (a) the Futures Model; (b) the Legal Segregation with Operational Commingling Model ("LSOC"); (c) the Legal Segregation with Recourse Model; and (d) the Physical Segregation Model.[5/]

Futures Model

In the NPRM, the Commission described the customer segregation model used in the futures industry, where all of the rights and obligations of all of an FCM's cleared swaps customers, as well as all collateral supporting those rights and obligations, are kept in a separate, omnibus account at the DCO.[6/] In the case of a "double default" – where both a customer and its FCM defaults – the DCO has access to all the collateral of the defaulting and non-defaulting customers as part of the "waterfall" of resources available to it in the event of a default.[7/] Under the Futures Model, DCOs are able to use this collateral even before using their own capital or their guaranty fund.[8/] Further, under this model, though the FCM's books and records indicate the collateral for individual customers, the FCM does not generally share this information with the relevant DCOs. Therefore, on the day of default, customer accounts are not easily portable, because DCOs lack current information on each customer's collateral.[9/]

Legal Segregation with Operational Commingling Model ("LSOC" or "Complete Legal Segregation Model")

The NPRM also described the LSOC model, in which all of an FCM's cleared swaps customers' collateral is kept in a separate omnibus account at the DCO, a bank or other location.[10/] Under this model, this separate account could not include or be commingled with any other types of funds, such as the DCO's or FCM's proprietary funds, the funds of the FCM's non-cleared swaps customers, or the FCM's other customer funds.[11/] Further, as part of the model, the FCM manages this fund in the aggregate; the FCM makes all payments and collections of initial and variation margin, posts collateral, and invests, all on an omnibus basis.[12/]

While the FCM's cleared swaps customers' collateral is physically kept together in an omnibus account, in the FCM's and DCO's books and records, the customers' swaps and relevant collateral are accounted for individually.[13/] Further, prior to a customer or FCM default, the only entities which have access to an individual customer's collateral are the customer and the FCM.[14/] Also, FCMs provide daily reports to the relevant DCOs on the portfolio of rights and obligations of each individual cleared swaps customer.[15/]

[5/] *See* "Notice of Proposed Rulemaking on the Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions," 76 *Fed. Reg*. 33818 (June 9, 2011).
[6/] *See* 75 *Fed. Reg*. 75164.
[7/] *Id*; *see also* 77 *Fed. Reg.* 6338.
[8/] *See* 75 *Fed. Reg.* 75164.
[9/] *See* 76 *Fed. Reg.* 33821.
[10/] *See* 77 *Fed. Reg.* 6339.
[11/] *Id*.
[12/] *See* 75 *Fed. Reg.* 75164; *see also* 77 *Fed. Reg.* 6339.
[13/] *Id*.
[14/] *Id*.
[15/] *See* 75 *Fed. Reg.* 75164.

In accordance with this model, FCMs are obligated to ensure that the DCOs could not use the collateral of a cleared swaps customer to support the obligation of another customer by maintaining the value of the cleared swaps customer collateral in the DCO account at an amount that equals or exceeds the value of the cleared swaps customer collateral the FCM has received to secure the customer accounts.[16/] Finally, one of the key provisions of this model is that, in the event of a double default, the DCO is not allowed access to the collateral of the defaulting FCM's non-defaulting customers to meet the obligations of its defaulting customers or the FCM itself.[17/]

Legal Segregation with Recourse Model

As described in the NPRM, the Legal Segregation with Recourse Model is a hybrid of the LSOC model and the Futures Model. Like LSOC, in the Legal Segregation with Recourse Model, the cleared swaps customers' collateral are held collectively in an omnibus account, but are recorded as individual accounts; and prior to a default, only the cleared swaps customer and the FCM are able to access each account.[18/] Also, as in the LSOC model, the FCM ensures that the DCO cannot use the collateral of a cleared swaps customer to support the obligation of another customer, by maintaining the value of the cleared swaps customer collateral in the DCO account at an amount that equals or exceeds the value of the cleared swaps customer collateral the FCM has received to secure the customer accounts.[19/]

In the event of a double default, however, this model is similar to the Futures Model in that a DCO is not prohibited from including the collateral of the FCM's non-defaulting customers in its "waterfall."[20/] Unlike the Futures Model, however, the DCO first has to use its own capital and the guaranty fund contributions of all members before it can access the funds of the FCM's non-defaulting customers.[21/]

Physical Segregation Model

Under the Physical Segregation Model, the FCM and DCO reflect individual cleared swaps customers' collateral in their books and records and DCOs cannot access non-defaulting cleared swaps customer collateral in case of a default of another customer or the FCM.[22/] Unlike LSOC or any of the other models, however, cleared swaps customer collateral are also physically segregated by customer.[23/] Since their funds are in separate accounts, customers would not be vulnerable to the risk of other customers' accounts.[24/]

[16/] *See* 77 *Fed. Reg.* 6339.
[17/] *Id.*
[18/] *Id.*
[19/] *Id.*
[20/] *Id.*
[21/] *Id.* Given the substantial resources that DCO's maintain, this provision should make it very unlikely that the DCO would access customer funds. *See* 75 *Fed. Reg.* 75164.
[22/] *Id.*
[23/] *See* 77 *Fed. Reg.* 6339.
[24/] *See* 75 *Fed. Reg.* 75164.

Commission's Consideration of the Segregation Models

As indicated in the text of the final rule and the NPRM, the Commission weighed the various models in regard to a number of factors, including fellow-customer risk, investment risk, operational risk, portability, operational costs, and bankruptcy protection.

Fellow-Customer Risk

The Commission defined "fellow-customer risk" as "the risk that a DCO would need to access the collateral of non-defaulting cleared swaps customers to cure an FCM default."[25/] In regard to this risk, the Commission noted that the Physical Segregation Model provided complete protection in that DCOs are prohibited from using the collateral of non-defaulting customers to cure losses from defaulting customers.[26/] The Commission noted that LSOC provided less protection since, though DCOs could not access the accounts of non-defaulting customers to cure the losses of defaulting customers, DCO's would only have information regarding each customer's collateral from the close of business on the day before the default. Without up-to-date information on the day of default, there is a risk that DCOs may not accurately allocate collateral between defaulting and non-defaulting customers.[27/] The Commission further noted that the Legal Segregation with Recourse Model provides even less protection against fellow-customer risk in that DCOs would have access to the collateral of non-defaulting customers of an FCM in case of the FCM's default, though that access would only occur in the extreme circumstance when a DCO's own resources were not sufficient to cover the loss.[28/] The Commission acknowledged that the Futures Model provides no real protection from fellow-customer risk in that, in the event of an FCM default, the DCO had unfettered access to the collateral of non-defaulting customers to cover the loss.[29/]

Investment Risk

The Commission noted that "investment risk" is "the risk that each Cleared Swaps Customer would share pro rata in any decline in the value of FCM or DCO investments of Cleared Swaps Customer Collateral."[30/] The Commission stated that the Physical Segregation Model eliminated investment risk since each customer's collateral is held in a separate account and, as such, the investment loss of one customer would not affect another customer.[31/] The Commission acknowledged that the other models, on the other hand, would not provide protection against investment risk since they all permit FCMs and DCOs to hold all customer collateral in omnibus accounts and, as such, neither the FCM nor DCO would be able to attribute investment loss to individual customers.[32/] Thus, with the LSOC model, cleared swaps customers are protected from the losses on the specific positions of other customers, but are still vulnerable to losses due to a devaluation of the overall margin account as a result of market fluctuation.[33/]

[25/] *See* 77 *Fed. Reg.* 6338.
[26/] *See* 76 *Fed. Reg.* 33826.
[27/] *Id*, fn 72.
[28/] *See* 76 *Fed. Reg.* 33827.
[29/] *See* 75 *Fed. Reg.* 75164.
[30/] *See* 77 *Fed. Reg.* 6341, fn 28.
[31/] *See* 76 *Fed. Reg.* 33827.
[32/] *Id*.
[33/] *See* 75 *Fed. Reg.* 75164.

Operational Risk

As the Commission noted, "operational risk" is "the risk that, due to fraud, incompetence, or other mishap, customer funds that are required to be segregated are lost."[34/] The Commission acknowledged that operational risk is shared by all of the models. The possibility that an FCM may misappropriate customer funds is a vulnerability, to which none of the segregation models, are impervious.

Portability

The Commission determined that the Physical Segregation Model and the LSOC Model provided the best conditions for portability since, as a result of the fact that the DCOs could not access the collateral of non-defaulting customers, that collateral would be readily available to be ported to another FCM.[35/] The Commission noted that, in the case of the Legal Segregation with Recourse Model, and even more so with the Futures Model, portability would be hampered as the DCO would likely delay release of the collateral of non-defaulting customers until the positions of defaulting customers and the defaulting FCM are liquidated.[36/] Moreover, under these latter models, even if the DCO permits transfer of the swaps of non-defaulting customers, the receiving FCM may demand additional collateral to support the swaps which the non-defaulting customer may not be able to provide, particularly in times of market stress.[37/] The Commission noted that portability was a significant issue because timely portability of the cleared swaps of non-defaulting customers helps to mitigate systemic risk.[38/]

Operational Costs

The Commission noted that all of the segregation models would increase operational costs. The Commission determined, however, that the "operational costs for Physical Segregation would be substantially higher than the operational costs for [LSOC] … [and] would provide only incremental advantages …."[39/]

Bankruptcy

In the preamble to the final rule, the Commission also described how the bankruptcy provisions related to the four segregation alternatives. The Commission noted that if an FCM goes into bankruptcy for reasons other than the loss of customer funds – such as losses in the proprietary accounts or a loss related to the parent company – and the customer funds are not affected, customer funds would be available for transfer to another FCM, regardless of the segregation model used.[40/] The Commission did acknowledge, however, that given that the Legal Segregation models (Physical Segregation, LSOC and Legal Segregation with Recourse), unlike the Futures Model, require that customer account information is sent to the DCO daily, it makes

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[34/] *See* 77 *Fed. Reg.* 6348.
[35/] *See* 76 *Fed. Reg.* 33827.
[36/] *Id*.
[37/] *Id*.
[38/] *Id*.
[39/] *See* 77 *Fed. Reg.* 6343.
[40/] *See* 77 *Fed. Reg.* 6340.

it easier for a DCO to transfer funds since it would not have to rely on information from the defaulting FCM on the day of default.[41/]

The Commission noted, however, that if an FCM goes into bankruptcy and the customer funds suffer a loss as a result of fellow-customer risk, operational risk, or investment risk, customer collateral is subject to Section 766(h) of the Bankruptcy Code ("Code") (and Part 190 of the CFTC regulations) which provides that "the trustee shall distribute customer property ratably to customers on the basis and to the extent of such customers' allowed net equity claims …." Thus, the Commission acknowledged that all of the segregation models, including Physical Segregation, would not prevent non-defaulting customers' collateral from being distributed pro rata in the case of an FCM bankruptcy since, regardless of location, the collateral would still be defined under the code as "customer property."[42/] As the Commission stated, "Under all of the segregation models, to the extent there is a shortfall, each customer will ultimately receive the same cents-on-the-dollar proportion of the value of the customer's account."[43/]

The Final Rules: LSOC

During an Open Meeting on January 11, 2012, the Commission voted to adopt LSOC as the final rule for segregation of customer collateral for cleared swaps. The final rule was published in the *Federal Register* on February 7, 2012,[44/] and became effective on April 9, 2012, though compliance with the rule is not required until November 8, 2012.[45/] In the preamble to the rule, the Commission provided its rationale for adopting the LSOC model. It reasoned that: (a) LSOC provided greater protection from fellow-customer risk and provided faster porting than the Futures Model;[46/] (b) LSOC had similar operating costs to the Legal Segregation with Recourse Model, but provided better protection against fellow-customer risk;[47/] and (c) LSOC had substantially less operational costs than the Physical Segregation Model and was only slightly

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[41/] *Id*. Physical segregation is even more effective in this regard than the other segregation models in that under the other segregation models, the DCO would only have information regarding each customer's collateral from the day before, and the value of that collateral would most likely be changed on the day of default. Thus, DCOs would not have the most up-to-date information when allocating collateral between defaulting and non-defaulting customers. 76 *Fed. Reg.* 33826, fn 72.

[42/] This also includes the third party safe-keeping accounts that the Commission clarified that FCMs could use to maintain cleared swaps customer accounts. In this rule-making, the Commission made clear that the repeal of the 1984 segregation memo ("Amendment of Interpretation," 70 *Fed. Reg.* 24768, May 11, 2005 of The Underlying Financial and Segregation Interpretation No. 10 (Comm. Fut. L. Rep. (CCH) ¶7120 (May 23, 1984)) for futures, did not apply to cleared swaps. As the Commission made clear, however, the collateral in these accounts would still be considered customer property and, as such, subject to pro rata distribution in the case of an FCM bankruptcy. Further, in accordance with the memo, FCM's would have largely unfettered access to the funds in the third-party accounts and customers would need the FCM's consent to access the funds. 77 *Fed. Reg.* 6343.

[43/] *See* 77 *Fed. Reg.* 6338, 6340. Though, given that the Legal Segregation models (Physical Segregation, LSOC and Legal Segregation with Recourse) – unlike the Futures Model – require that customer account information is sent to the DCO daily, it makes it easier for a DCO to transfer funds without relying on information from the FCM after the default. Physical Segregation provides the most comprehensive protection since it is the only segregation model in which DCOs would have up-to-date information on the customer collateral in the segregated accounts. 76 *Fed. Reg.* 33826, fn 72.

[44/] To support the segregation requirements, the Commission has also required that FCMs post initial margin to the DCOs on a gross basis for each of the FCM's cleared swaps customers. § 39.13(g)(8). "Derivatives Clearing Organization General Provisions and Core Principles," 76 *Fed. Reg.* 69334 (November 8, 2011).

[45/] *See* 77 *Fed. Reg*. 6336. Compliance with the Part 190 sections of the rule, however, became effective on April 9, 2012. 76 *Fed. Reg*. 6360.

[46/] *See* 77 *Fed. Reg.* 6349.

[47/] *See* 77 *Fed. Reg.* 6343.

less effective in protecting against fellow-customer risk.[48/] The Commission also noted that, although a major benefit of the Physical Segregation Model was that it eliminated investment risk, the Commission was planning to, and has, amended Rule 1.25.[49/]

The Final Rule Provisions Implementing LSOC

The final rule added Part 22, which mandates the segregation of cleared swaps customers swaps and attendant collateral, and amended Part 190 of the CFTC bankruptcy regulations. Part 22 of the rule has several requirements, including that: (a) FCM's must treat cleared swaps customers' cleared swaps and associated collateral as belonging to the customer;[50/] (b) these funds must be physically segregated from the FCM's own property and from that of other customers;[51/] (c) the funds of one cleared swaps customer cannot be used to meet the obligations of another cleared swaps customer or anyone else;[52/] (d) FCMs cannot impose a lien on cleared swaps customer collateral; [53/] (e) the funds must be held at the FCM, the DCO or another "permitted depository";[54/] and (f) the situs of the cleared swaps customer accounts must be in the U.S.[55/]

The final rule allows FCMs, however, to commingle the collateral from multiple cleared swaps customers,[56/] and to make "permitted investments" with this customer collateral in accordance with § 1.25.[57/] Further, under the rule, FCMs must compute and send to the relevant DCOs at the close of each business day: (a) the aggregate market value of the collateral in the account of each cleared swaps customer; (b) the level of margin required for each account; and (c) the FCM's residual interest[58/] in each cleared swaps customer's account.[59/]

In regard to DCOs, the rule requires that a DCO segregate customer collateral from its own funds and treat such collateral as belonging to the individual customer.[60/] Further, DCOs are required to monitor FCM's reporting, regarding customer collateral, for accuracy and timeliness.[61/] The rule also allows DCOs to commingle and invest the cleared swaps customers' collateral of the customers of multiple FCMs, in accordance with Rule 1.25.[62/]

Importantly, the rule allows FCMs and DCOs to collect excess collateral, based on the credit risk posed by individual customers.[63/] Further, the rule requires that the loss in value of the cleared swaps customers' collateral should be borne by all of the cleared swaps customers on a pro rata

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[48/] *Id.*
[49/] *Id*. *See infra* fn 57 for a description of § 1.25.
[50/] § 22.2(a).
[51/] § 22.2(d).
[52/] § 22.2(d).
[53/] § 22.2(d)(2).
[54/] § 22.2(b). "Permitted depository" includes bank or trust company located in the U.S.; or a collecting futures merchant or DCO registered with the Commission. § 22.4.
[55/] § 22.8.
[56/] §§ 22.2(c) and 22.2(d)(3).
[57/] § 22.2(e)(1). Under § 1.25(a), "permitted investments" include: (i) U.S. bonds; (ii) municipal bonds; (iii) government sponsored enterprise securities; (iv) certificates of deposit; (v) commercial paper; (vi) corporate notes or bonds; (vii) sovereign debt; and (viii) interests in money market mutual funds.
[58/] "Residual financial interest" in this context is the difference between the market value of the collateral and the amount of required margin. § 22.2(g)(1)(iii).
[59/] § 22.2(g).
[60/] §§ 22.3(a) and (b).
[61/] § 22.11(e).
[62/] § 22.3(c) and (d). *See supra* fn 57 for a description of § 1.25.
[63/] § 22.13.

basis.[64/] And significantly, the final rule allows that on the day of an FCM default, if a DCO is unable to obtain information from the FCM, it can rely on the information that the FCM provided on the previous day in determining how to allocate the customer collateral.[65/]

The final rule also amends the bankruptcy provisions of Part 190 in a number of ways, including defining cleared swaps accounts as an "account class," which must be recognized, by the bankruptcy trustee, as separate from other account classes, such as futures accounts and foreign futures accounts.[66/] On a related noted, section 724(b) of Dodd-Frank also amends Title 11 of the Bankruptcy Code to make clear that cleared swaps are "commodity contracts," within the meaning of section 761(4)(F) of the Bankruptcy Code; and, as such, the swaps and attendant collateral are subject to bankruptcy protection under Subchapter IV of Chapter 7 of the Bankruptcy Code. These protections include protected transfers of cleared swaps and related collateral; and preferential distribution of remaining collateral if swaps are subject to liquidation.[67/]

Next Steps

During the Open Commission meeting, the Commissioners discussed the effect of, and the public policies relating to, the Bankruptcy Codes' pro rata distribution requirement. The Commission also discussed the possible merits of further rulemaking to consider an additional form of segregation in which customer collateral would be held by the DCO directly, rather than by the FCM.

CFTC Roundtable on Enhancements to the Segregation Framework

On February 29, 2012, the CFTC began a two-day roundtable discussion to consider enhancements to the segregation framework, which was seen in part as a response to issues raised by the still pending MF Global bankruptcy proceeding.[68/] During the staff roundtable, the panelists discussed a wide range of issues, including possible modifications to Part 190 of the Commission's rules and extending the LSOC segregation framework to futures.[69/] One panel discussed an alternative segregation model proposed by the Chicago Mercantile Exchange – the "Guaranteed Clearing Participant" model.[70/]

[64/] § 22.14(e) and (f).
[65/] § 22.14(g).
[66/] § 190.01(a)(1).
[67/] *See* 77 *Fed. Reg*. 6337.
[68/] Though the roundtable was seen as partly a response to the MF Global bankruptcy, the CFTC staff prohibited the mentioning of the MF Global matter during the roundtable, as the Commission was still involved in regulatory actions.
[69/] The roundtable discussion sessions were: "LSOC for Futures," "Alternative Models for Custody of Customer Collateral," "Enhancing Customer Protection and Transparency Through an FCM on U.S. Futures Markets," "Commodity Broker Bankruptcies/Part 190," "Enhancing Protections for Customers Trading Through an FCM on Foreign Futures Markets – Part 30," "Issues Particular to Dually Registered FCMs and BDs," and "Self-Regulatory Organizations and Self-Regulatory Oversight."
[70/] Participants in this session entitled, "Alternative Models for Custody of Customer Collateral" included the Chicago Mercantile Exchange ("CME") and Committee on Investment of Employee Benefit Assets ("CIEBA"), the California Public Employees' Retirement System ("CalPERS"), Eurex Clearing, International Swaps and Derivatives Association ("ISDA"), Futures Industry Association ("FIA"), Harris Bank (settlement bank), Goldman Sachs, Deutsche Bank, LCH Clearnet, ICE Clear Credit, the Kansas City Board of Trade, and the National Futures Association ("NFA"). Members of the panel held divergent views on the proposal.

Guaranteed Clearing Participant Model ("GCP")

At the roundtable, the GCP model was described by a representative of the Committee on Investment of Employee Benefit Assets ("CIEBA"),[71/] who noted that the goals of the model were to: (a) shield customers from an FCM bankruptcy; (b) maintain customer monies in a fully transparent segregated account at a third party; and (c) protect client collateral from the misuse by FCMs, as that which occurred at MF Global.

The basic structure of the GCP model, as described by the CIEBA representative, is that participants would not be considered customers of the FCM, but rather special clearing members, or "guaranteed clearing participants," of the DCO. As such, they would have direct access to the DCO's clearing services, including posting margin directly to the DCO, and meeting their own margin calls.

Though they would be considered clearing members, the GCPs would not have the full responsibilities of clearing members; for instance, they would not contribute to the DCO's guaranty fund or obligate themselves to take on the customer positions of defaulting clearing members. In essence, the GCPs would really only be clearing members in regard to having direct access to the DCOs' settlement accounts. Since they would not take on the burdens of mutualization, the GCPs would need FCMs to serve as guarantors of their accounts to the DCOs. In this role, the FCMs would have access to the GCP accounts in order to "top up" margin to prevent a default to the DCO, but the FCMs would not be able to access the GCP accounts for any other reason.

The CIEBA representative noted that CIEBA was proposing that the GCP model be an option for market participants that were willing to pay the extra cost for the extra protection of the GCP model. The CIEBA representative did note, however, that CIEBA was requesting that the CFTC mandate that DCOs must offer or support the model in order for the model to be available to all customers. The CIEBA representative also noted that the model would include practices that provide some protection to FCMs, including that FCMs would: (a) be able to approve all new positions; (b) have real-time visibility of collateral in the GCP accounts; (c) have control of the GCP collateral; (d) be the liquidator in case of default; and (d) be able to require excess margin above the DCO minimum (though the excess margin would be held in the GCP account and be considered as the funds of the GCP). The CIEBA representative further noted that CIEBA was open to suggestions regarding how to promote portfolio margining within the GCP model.

The CIEBA representative argued that the GCP model would protect against FCM malfeasance, that the funds would not be considered customer funds, and, thus, would not have to be distributed pro rata in the event of an FCM bankruptcy, and that the GCP account would enable effective porting in the event of the bankruptcy of the FCM.[72/]

Several panel members questioned whether FCMs would have to maintain a lien over the GCP's collateral, and in so doing, exert control over the funds causing them to resemble customer

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[71/] Mark Szycher of GM Pension Plan.
[72/] The CIEBA representative emphasized that this last feature was a major attraction of this model for pension funds and other low-leveraged clients in that it was essential for them to maintain their swap positions for hedging purposes, and they did not want to run the risk of those positions being liquidated in the case of an FCM default.

property. If that is the case, the funds subject to the lien may be subject to the pro rata distribution under section 766(h) of the Bankruptcy Code. They also raised concerns about the effect that widespread adoption of the GCP model may have on clearing, i.e., whether differentiating between customers in this way might destabilize the system and shift risks from one group of customers to another. Accordingly, the roundtable revealed that, like the debate over the segregation models in general, there is a wide spectrum of views on this model.

Conclusion

Although the Commission has adopted final rules which will implement LSOC as the segregation model for cleared swaps, a number of significant issues remain open and are likely to be revisited by the Commission. Moreover, as the lessons of the MF Global Bankruptcy proceeding become evident, additional changes to the segregation framework may be proposed before the Commission's consideration of these issues is complete.