46. Trustee's Report, p. 177.
47. *Id*.
48. *Supra,* FN 39.
49. House Report, p. 76.
50. *Id*.
51. House Report, p. 79.
52. The SEC and CFTC could serve document requests or request testimony but all of that takes time, far more time than could possibly be devoted to obtaining the information by such means rather than by obtaining it directly from the staff of MF Global whose systems were strained or not functioning during the last week which prevented the MFGI staff from realizing the full extremity of the status of customer funds in segregation, secured or the 15c3-3 reserve account.
53. House Report, p. 83.
54. House Report, p. 87.
55. House Report, p. 88.
56. House Report, p. 90.
57. House Report, p. 92.
58. House Report, p. 94.
59. House Report, p. 95.
60. House Report, p. 96.

Trading Places: "Swaps" Morph Into "Futures" Via a CFTC 4d Order

ROBERT ZWIRB*

In October 2012, the CFTC approved a request by a prominent clearinghouse to allow both U.S. and non-U.S. energy futures to be held in the same segregated customer account.[1] In particular, the CFTC order permits the clearinghouse and its members to hold funds deposited to margin energy futures contracts that are cleared by that organization in a CEA Section 4d(a) account, the segregated customer account that historically has been limited to domestic futures and options.[2] In addition to allowing domestic and foreign futures to be held in a single account, the CFTC's order allows the clearinghouse to offer portfolio margining and margin offsets for such positions, thus effectively reducing the margin requirements for its customers.

These regulatory actions—the request by the clearinghouse and the approval of that request by CFTC—raise a number of important policy questions. For example, why is the clearinghouse here seeking to mix what are legally apples with oranges in the same account, *i.e.*, the funds of customers trading in futures cleared in the U.S. with those cleared abroad? Moreover, was it necessary to go to the trouble to seek regulatory permission to commingle U.S. and non-U.S. futures in 4d(a) account? After all, funds deposited by U.S. customers for foreign futures and options transactions already are afforded protection under CFTC Rule 30.7, which requires that property from foreign futures and foreign options customers be maintained in a separate account in what is known as a foreign futures or foreign options secured amount account.

Finally, and perhaps most significantly, is this action really about combining in one account

"futures" that are cleared in different jurisdictions—or is something larger going on?

Background

Under the Commodity Exchange Act ("CEA"), funds deposited by a customer with a futures commission merchant ("FCM") to secure futures, options, and certain swaps contracts must be maintained in a "segregated" account for the exclusive benefit of the depositing customer.[3] This does not mean that each customer has his own separately segregated account—indeed, customer property posted as collateral is segregated on an "omnibus" or pooled basis—it means only that funds of customers must be kept separate from funds of the FCM.

The segregation requirements provide important safeguards for futures customers. For example, they prohibit an FCM from using one customer's funds to margin another customer's positions. If one customer fails to post sufficient margin, the FCM is required to deposit its own funds into the customer-segregated omnibus account in order to protect the FCM's other customers against the default of that failing customer. In the event an FCM becomes insolvent, customers are given a priority in bankruptcy as to their segregated funds.

Beyond segregating customer funds from FCM funds, the CFTC bankruptcy rules also require the segregation of certain types of customer funds from other types. That is, the CFTC rules require the maintenance of separate pools or account classes of customer property (including separate pools for U.S. futures, foreign futures, and cleared swap accounts). The pools are distinguished in part by the degree to which such property is kept in segregation.[4] This approach reflects the fact that segregation requirements for some account classes are more stringent than for others.[5] Segregation by account type therefore means that customers whose funds are subject to the full stringency of segregation under CEA Section 4d(a) do not have to share their property in any potential liquidation of an FCM with customers whose property is subject to a more lenient form of segregation, such as, for example, funds subject to the less stringent Rule 30.7 foreign futures secured-amount requirement.[6]

Historically, the protections provided by the CEA's segregation requirements applied only to domestic exchange-traded contracts, *i.e.*, futures and commodity options traded on U.S. exchanges. Beginning in 2004, however, the CFTC extended these protections via orders issued pursuant to CEA Section 4d(a) ("Section 4d Orders") first to foreign futures and options, and then several years later, to "cleared-only contracts," *i.e.*, contracts that although not executed or traded on a Designated Contract Market ("DCM") are subsequently submitted for clearing through an FCM to a Derivatives Clearing Organization ("DCO").[7] Then in 2010, the CFTC amended its bankruptcy rules to create a new and completely separate account class for positions in "cleared OTC derivatives." These new rules gave futures-like protection to many cleared swaps, even without a Section 4d Order.[8] However, while domestic futures could be combined with foreign futures or cleared OTC swaps in a 4d(a) segregated account, the reverse was not true: futures could not be combined with cleared swaps in a cleared OTC account.[9]

The enactment of Dodd-Frank modified this general framework by requiring "cleared swaps" customer collateral be segregated in accordance with a new statutory provision (CEA Section 4d(f)) expressly for the segregation of cleared swaps.[10] Under this new framework, DCOs and clearing member FCMs may now commingle customer positions in futures and cleared swaps either in i) a Section 4d(a) futures account pursuant to a Section 4d Order issued by the Commission, *or* ii) a Section 4d(f) cleared swaps account pursuant to DCO rules approved by the Commission under CFTC Rule 40.5.[11]

So, today, the benefits of segregation have been extended to holders of foreign futures and cleared swaps. Moreover, today there are also three account types where futures and swaps collateral may be combined in somewhat different regimes: 1) the futures or Section 4d(a) account class, 2) the cleared swap or Section 4d(f) account class, and 3) the foreign futures or Rule 30.7 account class.[12]

Analysis

Before we can determine whether permitting U.S. and non-U.S. futures to be held in the same account is a positive or negative development for customers, we must first resolve what it is really going on, in particular:

(i) whether this is about combining U.S. futures with foreign futures, or

(ii) whether it is about combining swaps and futures.

While the petition states that it is about combining "energy futures with energy contracts that are foreign futures,"[13] it also notes and that "[t]hese products have previously been cleared . . . on an OTC basis."[14] This latter statement strongly suggests that the real purpose of the petition is to commingle "swaps," in particular the clearinghouse's energy swaps, with "futures" in the same segregated 4d(a) account, so that the swaps can be regulated as futures and not as swaps under Dodd-Frank.

How do "foreign futures" enter the picture? In addition to customer transactions involving foreign futures and options, the CFTC allows "non-regulated transactions" to be included in the CFTC Part 30.7 secured amount account for swaps not subject to a 4d order.[15] OTC derivatives cleared by clearing organizations such as LCH.Clearnet for U.S. customers have long been held in 30.7 accounts intended for *foreign futures and options*. That was because prior to 2010, there was no other place to park them that provided the benefits of segregation or equivalent protection other than in a 4d account, and the CFTC, as noted above, had already given its blessing to such an unusual arrangement. Although, another avenue opened up in 2010 for protecting the funds of OTC customers with the CFTC's designation of a new account class specifically for "cleared OTC derivatives" under CFTC Rule 190.01(a),[16] placing customer funds in this account class required the relevant clearinghouse to issue a rule or by-law for that purpose. By contrast, placing cleared OTC customer collateral in a 30.7 secured account avoided the legal costs and uncertainty associated with either of these two avenues, since there was no need for the clearinghouse to issue a rule or petition the Commission for a 4d order.

Moreover, whether due to inertia or otherwise, 30.7 remained the parking place for many cleared OTC derivatives even after the CFTC created a new account class for such transactions. Customers of Lehman Brothers and MF Global, however, discovered to their surprise that their positions in cleared OTC derivatives were held in 30.7 accounts and therefore subject to foreign rather than U.S. law when those firms failed, even where such positions were handled by U.S. FCMs and originated on U.S. exchanges such as the Nodal Exchange. More importantly, such distinctions have significant real world effects, for in the case of MF Global, while the Trustee in that insolvency proceeding to date has been able to return 93 cents on the dollar for 4d property, he has been able to return only five cents on the dollar for 30.7 property.[17]

The CFTC's approval of this petition to transfer of cleared swaps from a § 30.7 account to a 4d account, however, raises two questions. The first pertains to the legality of the move, *i.e.*, is it legally sound? Apparently so, since the CFTC says it is legally sound, although the petition candidly observes that CFTC Rule 39.15(b)(2), which establishes standards and procedures for the submission of a petition for an order under which futures, options, and swap positions may be held in the futures account subject to the requirements of CEA Sec. 4d(a) of the Act "does not specifically address commingling of foreign futures as opposed to swaps."[18]

The second question relates to the merits of such a move. Why not instead move these energy swaps to the new account class created by Dodd-Frank specifically for cleared swaps? That is, why does the clearinghouse here want to park them in a futures account rather than the new account class established for "cleared swaps" under CEA Section 4d(f)? Although the 4d(a) segregated futures account has always been considered the Cadillac of all account classes in terms of providing customer protection (at least until the advent of LSOC), the principal motivation here appears to involve the clearinghouse's desire to avoid subjecting these transactions to

the Dodd-Frank regulatory regime for swaps. Recall last summer, the clearinghouse involved here announced that it would begin a process of converting its energy "swaps" into "futures."[19] This petition is about carrying out the move. As the petition candidly acknowledges, this is about "transition[ing] certain of its cleared . . . OTC energy swap products to energy futures and options contracts."[20]

So the immediate effect of this action is to allow the clearinghouse to commingle its swaps with futures in a 4d segregated account. Is that good? It depends in part on where you are located on the clearing food chain. Recall that the CFTC's issuance of an interpretative statement in 2008 to treat "cleared OTC derivatives" as "commodity contracts," followed by its promulgation of a rule in 2010 to create a separate "account class" for such positions for bankruptcy purposes, initially raised concerns that i) the CFTC's view regarding the legal status of cleared OTC derivatives lacked legal authority and more importantly,[21] ii) that inflows of such derivatives into 4d accounts could threaten the integrity of those customer segregated accounts meant for futures and raise risks of default for clearing organizations and their customers.[22]

While the legal issue was rendered moot by Dodd-Frank's treatment of cleared swaps as "commodity contracts," the policy issue, by contrast, has never really been settled. In particular, commenters in 2009 to a similar petition by the CME to commingle customer funds used to margin credit default swaps with other funds held in segregated accounts expressed grave concerns that such commingling could delay or even prevent the transfer of exchange-traded futures positions to a solvent FCM.[23] While those concerns would ultimately not find acceptance by the CFTC,[24] that action did not quell the fundamental concerns resulting from mixing oranges and apples in the same account. Even the CFTC post-Dodd-Frank has implicitly acknowledged these concerns.[25] These continuing concerns illustrate the tensions that are sure to develop as OTC derivatives are swept into a legal framework that was originally intended to protect customers of insolvent *futures* commission merchants.

Conclusion

Obviously the portfolio margining benefits associated with combining swaps and futures in one account is a big positive for customers since margining such positions separately results in significant additional costs and inefficiencies. But even the clearinghouse here concedes that it "currently offers margin offsets between such products in the Rule 30.7 account class."[26]

As with any regulatory move of this nature, trade-offs are involved. While customers who invest in both futures and swaps will benefit, those that hold only futures may not like having their segregated benefits diluted by the presence of OTC newcomers. Conversely, those newcomers may have something to fear from having their funds commingled into futures accounts that do not have the benefit of new "LSOC" regime for swaps customers. But those trade-offs appear to be beside the point, for again what this action is really about is to allow the clearinghouse to morph its swaps into futures in order to avoid the more onerous regulatory burdens of Dodd-Frank applicable to swaps, and the CFTC to some surprise is going along. [27]

Thus, while Dodd-Frank may have cleared a path for cleared swaps customers to receive better protection in bankruptcy, the very onerous swaps regime is causing clearing organizations to close down that path. That is, the clearing organizations have seemingly decided that customers are better off sacrificing the bankruptcy protections afforded by the new regulatory regime if the customers can thereby avoid the regulatory burdens created by the new regime. So how much benefit is there to the new regime? As mentioned, there should be considerable benefit to customers from both a portfolio management perspective and from being able to avoid Dodd-Frank. But from a bankruptcy standpoint, it may not be that much, and arguably may be a detriment to existing futures customers.

NOTES

* Robert Zwirb is an independent legal consultant and a former counsel to the Chairman of the Commodity Futures Trading Commission. Please direct comments and questions to mailto:bzwirb@gmail.com.

1. CFTC Order, *Treatment of Funds Held in Connection with Clearing by ICE Clear Europe Limited of Contracts Traded on ICE Futures Europe and ICE Futures US* (Oct. 9, 2012).
2. More specifically, the order allows ICE Clear Europe and its clearing members to commingle customer property used for margining contacts traded on ICE Futures Europe, and cleared through ICE Clear Europe, to be commingled with futures that are traded on ICE Futures US and cleared through ICE Clear Europe in what is known as a "Section 4d(a) account," the segregated account usually reserved for domestic futures and options under Section 4d(a) of the CEA.
3. CEA Section 4d.
4. *See* CFTC Rule 190.01(a)(1).
5. 46 Fed. Reg. 57535, 57554 (Nov. 24, 1981) (noting that "much of the benefit of segregation would be lost if property segregated on behalf of a particular account class could be used to pay the claims of customers of a different account for which less stringent segregation provisions were in effect").
6. See 69 Fed. Reg. 69510, 69511 (Nov. 30, 2004) (Interpretative Statement).
7. See 69 Fed. Reg. 69510 (Nov. 30, 2004) (interpretative statement permitting funds supporting foreign futures to be deposited in a futures account and segregated in accordance with CEA Section 4d) and 73 Fed. Reg. 65514 (Nov. 4, 2008) (interpretative statement clarifying that property margining "cleared-only contracts," i.e., contracts not executed on a DCM, but submitted for clearing through an FCM to a DCO, may be included in a futures account and segregated in accordance with CEA Section 4d).
8. See 75 Fed. Reg. 17297, 17301 (Apr. 6, 2010) (treating OTC derivatives that a customer clears through an FCM with DCO-cleared OTC derivatives as commodity contracts). The new account class was made applicable only to the bankruptcy of a commodity broker that is an FCM.
9. See 77 Fed. Reg. 6336, 6360 (Feb. 7, 2012) (noting that "while section 4d(a)(2) of the CEA permitted the inclusion in the domestic futures account class of transactions and related collateral from outside that class, there was no similar provision permitting the inclusion in the cleared OTC account class of transactions and related collateral from outside that latter class").
10. In response to this new authority, the CFTC amended its definition of "account class" in Part 190 of its rules, reducing it from six classes to five and renaming the one pertaining to "cleared OTC derivatives" to "cleared swaps." As a result, today the types of customer accounts that must be recognized as separate classes of account by a trustee in bankruptcy are: futures accounts, foreign futures accounts, leverage accounts, delivery accounts, and cleared swaps accounts. CFTC Rule 190.01(a)(1).
11. See CFTC Rule 39.15(b)(2). At the same time, the CFTC adopted for cleared swaps only a new model of segregation called the "legally segregated operationally commingled model" or "LSOC" that provides enhanced protections for the collateral associated with such swaps in the event of an FCM insolvency than that provided under the traditional futures model. See Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions, 77 Fed. Reg. 6336, 6349 (Feb. 7, 2012) (Final Rule).
12. The CFTC in October 2012 proposed prohibiting FCMs from holding any positions in a Part 30 secured amount account other than customers' foreign futures and option positions and associated margin collateral. See CFTC Notice of Proposed Rulemaking, Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations, at 128-129 (Oct. 23, 2012).
13. Letter from Paul Swann, President & Chief Operating Officer, ICE Clear Europe, ICE Clear Europe, to CFTC, Petition for an Order Pursuant to Section 4d(a) of the Commodity Exchange Act to Permit Commingling of Customer Funds in Connection with Energy Futures and Foreign Futures Contracts, at 1 (Aug. 6, 2012) ("ICE Clear Europe Petition").
14. *Id*. at 5.
15. See CFTC Advisory 87-4 (Nov. 18, 1987) and CME Advisory Notice AIB 08-05 (Oct. 10, 2008).
16. See 75 Fed. Reg. 17297 (Apr. 6, 2010).
17. Trustee's Ninth Interim Status Report on Claims, Inre MFGlobal, Debtor, Bankruptcy Case No. 11-2790 (MG) SIPA, Case No. 12-CV-6014, at 7 (Bankr. S.D.N.Y., Feb. 4, 2013).
18. ICE Clear Europe Petition at 4.

19. See ICE Press Release: IntercontinentalExchange to Transition Cleared Energy Swaps to Futures in October (Sep. 4, 2012).
20. ICE Clear Europe Petition at 2.
21. See 77 Fed. Reg. at 6360 (noting that when the CFTC in 2010 established a new account class for cleared OTC derivatives, "there were questions concerning the Commission's authority to require the segregation of cleared OTC derivatives (and related collateral) or to establish a separate account class for cleared OTC derivatives in a DCO insolvency.").
22. In particular, commenters to a petition by the CME to commingle customer funds used to margin credit default swaps with other funds held in segregated accounts, expressed concerns that such commingling could delay or even prevent the transfer of exchange-traded futures positions to a solvent FCM. See Revised Petition by CME, CME Submission # 08-175R (Dec. 21, 2009.
23. See e.g., Comment Letters by FIA and MF Global, Inc. & Newedge, USA LLC (Feb. 4, 2010) (questioning "the fundamental fairness . . . of requiring futures customers to cross-guarantee CDS contracts").
24. See 75 Fed. Reg. at 17298-99.
25. See 76 Fed. Reg. 69392 (Nov. 8, 2011) (observing that swaps "will expose DCOs to risks that can differ in their nature and magnitude").
26. ICE Clear Europe Petition at 2.
27. See Craig Pirrong, *A Swap By Any Other Name*, Streetwise Professor (Aug. 2, 2012) ("ICE has merely relabeled its cleared energy swaps as futures in order to avoid burdening its customers with the costs that [Dodd-Frank] imposes on swaps.").

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