Razor Alert

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Whose Money Is It, Where Is It, And When Is It Yours?

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Introduction

The MF Global case has focused press, regulatory, and customer attention again on who has which ownership rights in client property or funds at various times of the trading/investment/execution/clearing process. What you hear about the case – that the principle of segregation is sacrosanct – is true. But the definition and methods for segregation differ at different times during the course of a transaction.

How to Think (and Not Think) about Segregation

The word "segregation" means many things in different contexts. So two parties who think they have agreed to segregation may have different ideas of what was agreed. Generally, a financial firm must segregate: (1) its own property from those of its customers; and (2) the property of customer A from that of customer B. Segregation is of course necessary for a financial firm to satisfy its own and its customers' obligations.

"Segregation occurs when a clearing member [Which is a financial firm] is holding two or more separate collateral portfolios: one for itself and one for its customers. While it may be technically possible, and in some jurisdictions feasible, to apply segregation techniques on cash, in other jurisdictions this will be legally difficult if not impossible.[1] Segregation is generally achieved by the clearing member lodging all customer collateral in a customer omnibus or consolidated account. In addition, a market practice is increasingly being considered under which the clearing member holds with the clearinghouse the collateral of its customers in individualized or "designated" accounts (i.e., in the name of each customer). In some jurisdictions, and depending on the type of collateral (e.g., cash or securities) and agreements between stakeholders (clearing

[1] See the "Report to the Supervisors of the Major OTC Derivatives Dealers on Proposals of Centralized CDS Clearing Solutions for the Segregation and Portability of Customer CDS Positions and Related Margin," letter delivered to the New York Federal Reserve on June 30, 2009 by an ad hoc group of market participants (www.managedfunds.org/members/downloads/Full%20Report.pdf).

members, clearinghouses, and customers), the collateral may be held at the clearing member, clearinghouse, or a custodian.

The main purpose of segregation is to protect customers against the risk that, in the event of the insolvency of their clearing member, the insolvency receiver of the failed clearing member keeps the customer's collateral to satisfy the obligations of the failed clearing member generally, instead of its obligations to the customer. [In the context of securities transactions,] this is typically achieved through specific provisions in so-called securities holding laws, through which customers depositing securities collateral with a clearing member acquire individual or collective property law rights in collateral pools held by that clearing member on behalf of its customers with custodians such as clearinghouses. By providing such protection, segregation enables a clearinghouse (or the regulator) to transfer both the defaulting clearing member's customers' exposures and their related collateral to another clearing member in an unhindered manner, which allows the customers to meet their settlement obligations and hedge their exposures as needed. However, even in cases of segregation, the practice of reuse may subject collateral to additional risk. To enhance protection to a customer of its collateral, collateral should be used only subject to the customer's specific authorization.

However, even though well-designed omnibus and individualized accounts both protect customers against the insolvency of a clearing member, these two techniques have different legal consequences. In most systems using customer omnibus accounts, when both a clearing member and customer become insolvent, the clearinghouse first applies the insolvent customer's collateral to satisfy the obligations of the failed clearing member. Then all collateral lodged into the omnibus account (including the collateral originally provided by non-defaulting customers) is used to satisfy any remaining obligations of the defaulting customer. (If a customer, but not the clearing member, fails, the clearing member will remain responsible to the

clearinghouse for the margin obligations of all its customers.) In contrast, if customers' individualized accounts are held and recognized at the clearinghouse level, only the collateral lodged in the individual account of a customer can be used to cover losses related to the default of that customer."[2]

Besides the sources quoted in the footnotes, I recommend reviewing: Report to the Supervisors of the Major OTC Derivatives Dealers on the Proposals of Centralized CDS Clearing Solutions for the Segregation and Portability of Customer CDS Positions and Related Margin, June 30, 2009;[3] and the two recent MF Global trustee reports, Report of the Trustee's Investigation and Recommendations[4] and First Report of Louis J Freeh, Chapter 11 Trustee of MF Global Holdings Ltd., et al., for the period October 31, 2011 through June 4, 2012.[5]

Goal of this Article

The goal of this article is to suggest what financial firms and their counterparties should consider when a customer's property or funds are kept, even momentarily, at a financial institution.

Terminology Used in this Article

This article will generally distinguish among the types of financial interests which can be in a proprietary or customer account. Otherwise securities, money, and derivatives are all referred to as property.

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[2] IMF. "Global Financial Stability Report: Meeting New Challenges to Stability and Building a Safer System." Page 104. Accessed 2012-05-17. <http://www.imf.org/external/pubs/ft/gfsr/2010/01/pdf/text.pdf>.

[3] ISDA. "Report to the Supervisors of the Major OTC Derivatives Dealers on the Proposals of Centralized CDS Clearing Solutions for the Segregation and Portability of Customer CDS Positions and Related Margin, June 30, 2009." Accessed 2012-06-17. <http://www.isda.org/credit/docs/Full-Report.pdf>.

[4] Hughes Hubbard & Reed LLP. "Report of the Trustee's Investigation and Recommendations." Accessed 2012-06-17. < http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/mfglobaliinvestreport060412.pdf>

[5] Morrison & Foerster LLP. "First Report of Louis J Freeh, Chapter 11 Trustee of MF Global Holdings Ltd., et al., for the period October 31, 2011 through June 4, 2012." Accessed 2012-06-17. <http://mfglobalcaseinfo.com/pdflib/711_15059.pdf>

Also generally, unless specifically required, the term financial firm in this article covers banks, broker-dealers, futures commission merchants (“FCMs”), financial conglomerate firms, and the new Dodd-Frank category of swaps dealers (for either cleared or uncleared swaps). Clearing firms and custodians are referred to as third parties. The goal is to analyze the principles involved rather than focus solely on the entities or specific rules for each entity. (This is useful because it is not always clear the type of regulators, products, or entities involved.) Examples for different kinds of financial firms and third parties are made with reference to the specific type of entity.

A client, account holder, or customer of a financial firm is referred to as a customer. Of course, a customer may be a financial firm or may be an individual or institutional investor (fund, pension fund, etc.). I have also changed quotations in order to use this terminology throughout.

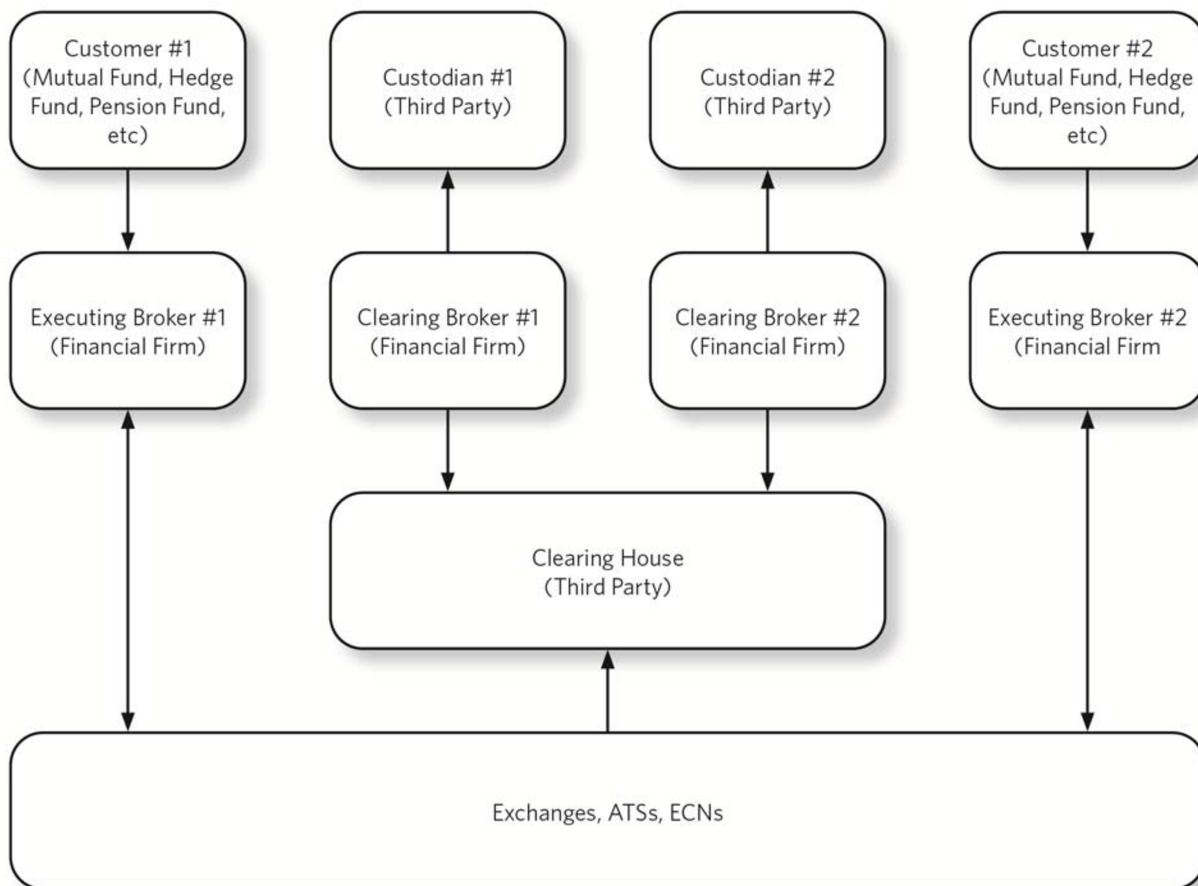
Trade/Investment/Execution/Clearing Process

Generally, for most products, the trade/investment/execution/clearing process works as follows:

- Orders are routed from the customers (one is a buyer, the other is a seller) to their respective executing brokers.
- The executing brokers send the orders to the appropriate marketplace for the [product] being traded. The marketplaces respond with executions ("fills").
- The executing brokers send the fills to the clearing broker that was designated by the [marketplace]. Many executing brokers are themselves clearing brokers, a term which is called "self-clearing."
- The marketplace(s) and the clearing brokers compare their shares/money to make sure that they match.

- The customers inform their respective custodians what they should expect to receive/deliver from the clearing brokers and the custodians perform this comparison.[6]

On settlement date, which is often trade date or the date when the actual trade occurred, the clearing brokers will deliver/receive the match amount of [property] to settle the trade with both executing brokers.



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[6] Wikipedia. "Central Counterparty Clearing." Accessed 2012-03-06. <http://en.wikipedia.org/wiki/Central_Counterparty_Clearing>.

[7] "A clearinghouse is a financial institution that provides clearing and settlement services for financial and commodities derivatives and securities transactions. These transactions may be executed on a futures exchange or securities exchange, as well as off-exchange in the OTC market. A clearinghouse stands between two clearing firms (also known as member firms or clearing participants) and its purpose is to reduce the risk of one (or more) clearing firm failing to honor its trade settlement obligations. A clearinghouse reduces the settlement risks by netting offsetting transactions between multiple counterparties, by requiring collateral deposits (a.k.a. margin

What You Are Told, What You Think You Get, and What You Get Are Not Always the Same

1. The two main concerns in segregation should be: how to identify customer property and how to retrieve it. Different segregation rules and practices exist based on the purpose of the segregation. Counterparties should consider whether the purpose of segregation is: (1) to **retrieve** property, funds, or collateral; or (2) to **identify** such property for: (i) reports to regulators re customer funds; (ii) disclosures to shareholders or counterparties about financial firm's assets; (iii) internal financial firm reports; (iv) issuance of reports to customer/counterparties; (v) temporary investment of funds; (vi) reports to and from clearinghouse's and custodians to keep track of positions; (vii) aggregation of customer funds; or (viii) liquidation of financial firms, the counterparty, other financial firm counterparties, the clearinghouse, or custodian. Therefore, asking "Is your property segregated?" is never enough.

2. Regulators may impede the ability to retrieve property as a financial firm fails. Even if they receive adequate assurances and proof of segregation, customers also need to consider that in case of an actual or imminent liquidation of a financial firm or counterparty, the customer's rights to its property may differ from its expectations depending on whether a regulator/trustee in bankruptcy may seek to ring fence assets of the financial institution. Such ring fencing would be to protect local markets or counterparties of the financial firm in the regulator's jurisdiction. Moreover, a regulator

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deposits), by providing independent valuation of trades and collateral, by monitoring the credit worthiness of the clearing firms, and in many cases, by providing a guarantee fund that can be used to cover losses that exceed a defaulting clearing firm's collateral on deposit. Once a trade has been executed by two counterparties either on an exchange, or in the OTC markets, the trade can be handed over to a clearinghouse which then steps between the two original traders' clearing firms and assumes the legal counterparty risk for the trade. This process of transferring the trade title to the clearinghouse is called novation. It can take fractions of seconds in highly liquid futures markets; or days, or even weeks in some OTC markets." Wikipedia. "Clearinghouse." Accessed 2012-03-30. < http://en.wikipedia.org/wiki/Clearing_house_(finance)>.

may seek to ring fence assets in anticipation of a financial problem at a regulated firm or as the problem occurs. Although regulators may under certain circumstances pledge not to ring fence assets or down play their ability to do so, there are many ways to achieve ring fencing to serve parochial interests and the result may be adverse to certain customer's interests.

In the case of Lehman Brothers and MF Global, regulators/trustees have delayed payment of full amounts to customers in order to manage the claims. In the liquidation of commercial banks, in order to ensure payment to local depositors, regulators have often ring fenced assets of local operations to prevent their being used to pay creditors in other jurisdictions.

3. What to look out for. The processes and records for segregation may vary even in a single transaction depending on the purpose of segregation. So a customer must review whether accounts are held separately from the financial institution and other customers. A customer should ask:

   - Are omnibus accounts used?
   - When customer property is held at another firm or held at a derivatives clearing organization ("DCO"), are such accounts held on an omnibus basis or held as separately identified accounts or an "in-house" division of the firm?

Counterparties should not just accept assurances that funds are segregated without knowing how, why, where, and when.

Moreover, customers should review legal opinions of their financial firm about the impact of liquidation on their property and executory contracts. For example, US

bankruptcy law generally treats executory contracts as enforceable (at the discretion of the trustee) as derivatives or qualified financial contracts to avoid systemic risk issues.

Technology Makes Segregation Easier (and Harder)

In this era, when every computer click seems to be monitored and recorded, you would think you could track almost anything. Technological advances generally enhance the ability of a financial firm to trace the ownership and use of customer funds. Nevertheless, technology also raises the potential for increased risk by allowing for more transfers of more products in greater amounts to more places, counterparties, and types of accounts.

For example, even a book-entry system for securities, with no evidence of ownership through physical control of property, increases operational risk. "When securities held through a financial firm are not segregated from the firm's own assets, the customer may be treated as having a general contractual claim against the financial firm instead of traceable property rights in individual securities.

In both civil law and common law countries, the failure to segregate would expose customers and secured creditors to the insolvency risk of their financial firms and potentially lead to systemic risk in the market in the event of insolvency of a sizeable intermediary.

The segregation of property on the books of the financial firm into proprietary accounts and customer accounts is important from an investor protection perspective. Failure by a financial firm to earmark customers' assets should not, however, convert the securities into the property of the nominee. Unfortunately, failure to properly segregate may substantially reduce the degree of practical protection from third-party claims which the system provides to customers. In all the participating countries with a central depository system, the customer holds his securities

through accounting records maintained by one or more tiers of intermediary institutions (financial firms and third-parties). The assets of the customer are only segregated legally from those of other customers in accounts maintained by the nominee. This makes it even more important for there to be proper segregation of securities on the books of the financial firm and the depository into proprietary accounts and customer accounts. In the civil law countries, property is held on trust for investors, so that even if the registered holder is not the ultimate owner of the property, they are still protected from the claims of creditors of the credit default swap in the event of insolvency of the financial firm."[8]

Seek and Ye Shall Find: The Obvious Signs of Segregation Problems

Signs of the existence of possible operational risks to proper segregation do appear. If you look hard enough, you should usually find when and how customer property is segregated. Nevertheless, even sophisticated customers may not focus on the operational risks created by the locations, regulatory regimes, products, multiple entities and accounts, documentation, and liquidation processes involved in a single transaction.

The following are three recent examples where the cracks in the segregation process should have been obvious. These examples also suggest that doubts about the ownership of customer property are endemic to the financial markets.

1. Lehman customers ignore obvious sign of segregation issues. For example, sophisticated hedge fund (and other) customers of Lehman Brothers UK still do not have access to their property because Lehman Brothers UK rehypothecated and reused such property. (Lehman Brothers US, in contrast, generally did not reyhpothecate customer property so

[8] Risk Insitute. "Legal and Regulatory Environment in CSDs, Mechanisms for Asset Segregation." Accessed 2012-03-06. <http://riskinstitute.ch/142880.htm>.

counterparties had speedier access to such property.) The Lehman UK customers, therefore, generally knowingly assumed the higher risk associated with rehypothecation because they signed contracts agreeing to it and also profited from it. Customers ignored the three obvious warning signs: a different rate of return in the two locations[9], different documentation in the two locations, and different approaches in the rules governing the treatment of customer funds.[10] The result was that when Lehman Brothers was liquidated, counterparties of the US entity were able to recover their funds more quickly and completely than the counterparties of the UK entity.

2. <u>JP Morgan Chase settles for treating Lehman customer funds like Lehman funds.</u> Recently: "JP Morgan Chase apparently confused Lehman Brothers funds from Lehman customer funds and held on to the customer money, about $333 million, even after Lehman failed. JP Morgan Chase agreed to pay $20 million to settle charges that the bank used customer funds to calculate how much credit to extend to Lehman Brothers Holdings Inc. in the two years leading up to the financial crisis thereby presumably lending Lehman more money and then withholding Lehman customer funds as if it was Lehman property.

   (Futures regulations regarding customer money dictate that the money should be accessible to customers at any time and should not be considered the firm's (in this context, Lehman's) assets.)

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[9] Arguably, counterparties of the UK operations, many of whom were also customers of the US operations, should have known that their collateral would be treated differently in the two locations. After all, the Lehman UK counterparties received a return for granting to Lehman UK the right to reuse the collateral and the contract allowed such reuse.

[10] Both jurisdictions generally require customer funds to be separately preserved and not reused, unless otherwise agreed.

In the JP Morgan case, the Commodities Futures Trading Commission ("CFTC") said that JP Morgan used the customer accounts to calculate Lehman's credit for intraday lending purposes for 22 months from November 2006 to September 2008 when Lehman failed. During that time, Lehman held between $250 million and $1 billion in customer money at JP Morgan."[11,12] The implication is that JP Morgan Chase should have known that it held Lehman customer property rather than Lehman property, and should have returned it, even if it had lent too much money to Lehman.

3. <u>In the MF Global case, JP Morgan Chase tried to clarify separation of MF Global funds versus MF Global customer funds.</u> In the MF Global case, JP Morgan Chase apparently recognized that funds MF Global used to satisfy debts to JP Morgan Chase could actually have been customer property and not MF Global property. "JP Morgan's role in the case has been closely watched because it was one of MF Global's key bankers. In the firm's final days of operation, JP Morgan was in frequent discussions with MF Global

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[11] Wall Street Journal. "JP Morgan to Pay $20 Million in Lehman Funds Case." Accessed 2012-04-22. <http://online.wsj.com/article/SB10001424052702303299604577323510015406818.html?_nocache=1335144138089&user=welcome&mg=id-wsj>.

[12] The CFTC order finds that from at least November 2006 to September 2008, JP Morgan was a depository institution serving LBI, an FCM registered with the CFTC. During this time, LBI deposited its customers' segregated funds with JP Morgan in large amounts that varied in size, but almost always more than $250 million at any one time. According to the order, during the same time period, JP Morgan extended intra-day credit to LBI on a daily basis to facilitate LBI's proprietary transactions, including repurchase agreements, or "repos." JP Morgan would extend intra-day credit to LBI to the extent that LBI's "net free equity" at JP Morgan was positive. As of November 17, 2006, JP Morgan included LBI's customer segregated funds in its calculation of LBI's net free equity, even though these funds belonged to LBI's customers, not to LBI, the order also finds. The Commodity Exchange Act and CFTC regulations prohibit depository institutions, like JP Morgan, from using or holding segregated funds that belong to an FCM's customer as though they belong to anyone other than that customer, and also prohibit the extension of credit based on such funds to anyone other than that customer. According to the order, JP Morgan violated these prohibitions in two ways. First, as stated in the order, JP Morgan extended intra-day credit to LBI for approximately 22 months based in part on LBI customers' segregated funds because those funds were included in JP Morgan's determination of LBI's net free equity. Second, on September 15, 2008, Lehman Brothers Holding, Inc. filed for bankruptcy. Two days later, LBI requested that JP Morgan release LBI's customers' segregated funds. JP Morgan improperly declined the request based on JP Morgan's determination that LBI no longer had positive net free equity held at JP Morgan. JP Morgan continued to refuse to release these funds for approximately two weeks thereafter, only to release the funds after being instructed by CFTC officials. The CFTC order does not find that there were any customer losses. CFTC. "CFTC Orders JPMorgan Chase Bank, N.A. to Pay a $20 Million Civil Monetary Penalty to Settle CFTC Charges of Unlawfully Handling Customer Segregated Funds." Accessed 2012-05-16. < http://www.cftc.gov/PressRoom/PressReleases/pr6225-12>.

executives, protecting its interests as a large lender to the securities firm and serving as a clearing bank that was a type of traffic cop as MF Global tried to unwind trading positions to raise cash."[13]

JP Morgan Chase asked MF Global several times to confirm the legality of its transfers to JP Morgan and that the funds transferred belonged to MF Global. The fact that such questions of whose property is it could even arise suggests that doubts about customer property ownership may be usual.

"The [MF Global] trustee has been working with JP Morgan for weeks but it is unclear when substantive discussions began on a possible settlement. It is also possible the trustee would sue JP Morgan or others to try to reclaim assets if he finds that other parties shouldn't have accepted money from MF Global in the days before its bankruptcy, a person familiar with the matter said in recent weeks."[14]

These cases demonstrate that even sophisticated parties can misconstrue whether customer funds of a financial firm belong to the financial firm.

What is so Tough about Achieving Segregation?

Why do we have these repeated problems with segregation? This article shows the number of firms and processes that are involved in the trading/executing/clearing process. Customer property can "fall between the cracks." What guidance exists to help us recognize operational challenges to achieving segregation? Securities and Exchange Commission ("SEC") Rule 15c3-3

[13] Wall Street Journal. "MF Global Trustee in Talks With J.P Morgan." Accessed 2012-04-22. <http://online.wsj.com/article/SB10001424052702304072004577326352198319654.html>.
[14] Wall Street Journal. "MF Global Trustee in Talks With J.P Morgan." Accessed 2012-04-22. <http://online.wsj.com/article/SB10001424052702304072004577326352198319654.html>.

suggests where the challenges are. Generally, the SEC requires broker-dealers to obtain and maintain the physical possession or control of all fully-paid securities and excess margin securities carried by a broker or dealer for the account of customers. (Other regulators have similar requirements.) The rule points to stages in a transaction when a broker-dealer (and, by analogy, other firms) may face operational challenges to segregation. So the challenges to achieving segregation arise through time lags, reuse of customer property, the use of omnibus or commingled accounts, transfers of property, and the use of multiple entities.[15]

Therefore, customers should ask:

- a financial firm to document how funds are invested and transactions effected;
- what entities the financial firm uses to effect such investments;
- whether any kind of funds or property are not segregated;
- what would happen if the financial firm – or its counterparties (including third-parties) – defaulted; and
- whether they are exposed to fellow customer risk.

1. <u>How to mitigate operational challenges to segregation.</u> Various regulators have articulated different approaches for mitigating operational risks that arise in protecting property. For example, the SEC notes that a financial firm may mitigate operational risks

[15] Such stages include: (1) temporary lags which occur between the time when a customer's property is required to be in the possession or control of the financial firm and the time that the customer places the property in the physical possession or control of the financial firm; (2) when fully paid or excess margin securities are borrowed from any person; (3) when the property is represented by one or more certificates in the custody or control of a clearing corporation; (4) when the property is carried for the accounts of any customer by a financial firm and are carried in a special omnibus account in the name of another financial firm or third-party; (5) the times when the subject property is a transfer (transmitted for transfer by the financial firm to the issuer or its transfer agent); (6) the property is in the custody of a foreign depository, foreign clearing agency, or foreign custodian bank; and (7) the property is held or is in transit between offices of the financial firm or held by an affiliate; (8) or the property is held in other locations.

by taking certain actions to document title, ensure an absence of liens, ensure communication among parties involved, and comply with certain regulations.

The following examples from the securities, banking, futures, and swaps contexts illustrate some measures for risk mitigation to enhance a customer's ability to identify and retrieve its property. These examples are mostly regulatory requirements imposed on financial firms, but they also suggest what a customer should ask, review, and consider.

a. Securities transactions. SEC Customer Protection Rule 15c3-3 requires a broker-dealer to protect the credit balances and securities it holds for customers by segregating customer funds and fully paid and excess margin securities held by the firm for the accounts of customers.[16] The rule demonstrates that the elements important to customer property protection are: (1) physical possession or control of customer property; (2) separate segregated broker accounts; (3) weekly and daily calculations of amounts of property held and amounts the broker-dealer owes the customer; and (4) restrictions on reuses of customer property. "The intent of the rule is to require a broker-dealer to hold customer [property] in a manner [and according to a formula] that enable[s] [its] prompt return in the event of an insolvency, which, in turn, increases the ability of the firm to wind down in an orderly self-liquidation and, thereby avoid the need for a proceeding under the Securities Investor Protection Act of 1970 ("SIPA")."[17,18,19,20]

[16] Subparagraph (a)(3) of Rule 15c3-3 defines "fully paid securities" as securities carried in any type of account for which the customer has made a full payment. Subparagraph (a)(5) defines "excess margin securities" as securities having a market value in excess of 140% of the amount the customer owes the broker-dealer and which the broker-dealer has designated as not constituting margin securities.
[17] 15 U.S.C. 78aaa et seq.

Note the SEC has proposed amendments to aspects of these rules dealing with the treatment of domestic and foreign broker-dealers as customers.[21] These

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[18] 17 CFR 240 [Release No. 34-55431; File No. S7-08-07] RIN 3235-AJ85 Amendments to Financial Responsibility Rules for Broker-Dealers." Page 3. Accessed 2012-05-16. < http://www.sec.gov/rules/proposed/2007/34-55431.pdf>.

[19] 17 CFR 240.15c3-3(e)(3).

"If, under the formula, customer credit items exceed customer debit items, the broker-dealer must maintain cash or qualified securities in that net amount in a 'Special Reserve Bank Account for the Exclusive Benefit of Customers.' This account must be segregated from any other bank account of the broker-dealer. Generally, a broker-dealer with a deposit requirement of $1 million or more computes its reserve requirement on a weekly basis as of the close of the last business day of the week (usually Friday)."

SEC. "SECURITIES AND EXCHANGE COMMISSION 17 CFR Part 240 [Release No. 34-55431; File No. S7-08-07] RIN 3235-AJ85 Amendments to Financial Responsibility Rules for Broker-Dealers." Page 4. Accessed 2012-05-16. < http://www.sec.gov/rules/proposed/2007/34-55431.pdf>.

[20] 17 CFR 240.15c3-3(b)(1).

"As noted, Rule 15c3-3 also requires a broker-dealer to maintain physical possession or control of all fully paid and excess margin securities carried for customers. This means the broker-dealer cannot lend or hypothecate these securities and must hold them itself or, as is more common, in a satisfactory control location."

SEC. "SECURITIES AND EXCHANGE COMMISSION 17 CFR Part 240 [Release No. 34-55431; File No. S7-08-07] RIN 3235-AJ85 Amendments to Financial Responsibility Rules for Broker-Dealers." Page 4. Accessed 2012-05-16. < http://www.sec.gov/rules/proposed/2007/34-55431.pdf>.

[21] 17 CFR 240.15c3-3(d)

Proprietary Accounts of Broker-Dealers. The SEC is proposing an amendment to Rule 15c3-3 that would require broker-dealers to treat accounts they carry for domestic and foreign broker-dealers in the same manner generally as "customer" accounts for the purposes of the reserve formula of Rule 15c3-3. [See 17 CFR 240.15c3-3(a)(1). This paragraph defines "customer" for the purposes of Rule 15c3-3. Broker-dealers, both domestic and foreign, are excluded from the definition and, consequently, are not treated as "customers" for the purposes of the rule's reserve and possession and control requirements. Some foreign broker-dealers also operate as banks. These firms are not deemed "customers" to the extent that their accounts at the US broker-dealer involve proprietary broker-dealer activities.]

The proposed amendment is intended to address an inconsistency between the way these proprietary accounts of broker-dealers are protected under Rule 15c3-3 and the SIPA. Specifically, because broker-dealers are not "customers" for purposes of Rule 15c3-3, a broker-dealer that carries the proprietary accounts of other broker-dealers is not required to include credit and debit items associated with those accounts in the customer reserve formula. Conversely, under SIPA, broker-dealers are considered "customers" and, consequently, entitled to certain protections. When a broker-dealer is liquidated under SIPA, an estate of customer property is created. [In particular, under SIPA, the pool of "customer property" is established using assets recovered from the failed broker-dealer.

proposed amendments highlight other concepts important to customer property protection including: (1) restricting broker-dealers from using affiliates to hold customer property; (2) treating broker-dealer customers of broker-dealers more like individual customers (who have certain additional protections right now); (3) restricting the use of customer balances; (4) regulating the allocation of customer property to short positions; (5) addressing the different treatment and regulatory protections of accounts which have contained securities and futures positions; and (6) addressing the way lending, borrowing, and repurchase transactions complicate segregation and computation of capital because broker-dealer capital

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The statute determines the assets that become a part of the pool of customer property. 15 U.S.C. 78lll(4). Customer property includes "cash and securities…at any time received, acquired, or held by or for the account of the debtor from or for the securities accounts of a customer, and the proceeds of any such property transferred by the debtor, including property unlawfully converted." Therefore, "customer property" includes those securities positions that are held for customers and the cash that is owed to customers. After being established, customer property is distributed to customers pro rata based on the amounts of their claims (i.e., their net equity). While broker-dealers are not entitled to advances from the SIPC fund to make up for shortfalls in the fund of customer property (see 15 U.S.C 78fff-3(a)(5)), they may be "customers" as that term is defined in SIPA and, therefore, entitled to a pro rata distribution from the fund of customer property.]

In order to correct the gap between Rule 15c3-3 and SIPA, the SEC proposes amendments to Rules 15c3-1, 15c3-3 and 15c3-3a that would require carrying broker-dealers to perform a separate reserve computation for proprietary accounts of other domestic and foreign broker-dealers in addition to the reserve computation currently required for "customer" accounts, and establish and fund a separate reserve account for the benefit of these domestic and foreign broker-dealers. [The amendment would exclude from the broker-dealer reserve computation accounts established by a broker-dealer that fully guarantees the obligations of, or whose accounts are fully guaranteed by, the clearing broker. In these circumstances, the guarantor must take deductions under Rule 15c3-1 for guaranteed obligations of the other firm. In addition, the amendment would exclude delivery-versus-payment and receipt-versus payment accounts. These types of accounts pose little risk of reducing the estate of customer property in a SIPA liquidation since they only hold assets for short periods of time.] This added protection also would mitigate potential contagion that might arise in the event of a failure of a broker-dealer with a large number of broker-dealer customers.

"In order to meet the possession or control requirement, a broker-dealer must determine on a daily basis the amount of customer fully paid and excess margin securities (by issuer and class) it holds for customers."

SEC. "SECURITIES AND EXCHANGE COMMISSION 17 CFR Part 240 [Release No. 34-55431; File No. S7-08-07] RIN 3235-AJ85 Amendments to Financial Responsibility Rules for Broker-Dealers." Pages 4-6. Accessed 2012-05-16. < http://www.sec.gov/rules/proposed/2007/34-55431.pdf>.

may not include unsecured receivables and whether a broker-dealer is acting as principal or agent.[22,23,24,25,26,27]

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[22] To address some of these risks, the SEC proposes an amendment to Rule 15c3-3 that would exclude cash deposits at affiliate banks for the purposes of meeting customer or PAB reserve requirements and place limitations on the amount of cash a broker-dealer could maintain in a customer or PAB special reserve bank account at one unaffiliated bank.

"Banks Where Special Reserve Deposits May Be Held. To the extent a broker-dealer deposits cash in a reserve bank account, there is a risk the cash could be lost or inaccessible for a period if the bank experiences financial difficulties. This could adversely impact the broker-dealer and its customers if the balance of the reserve deposit is concentrated at one bank in the form of cash. This risk may be heightened when the deposit is held at an affiliated bank in that the broker-dealer may not exercise due diligence with the same degree of impartiality when assessing the financial soundness of an affiliate bank as it would with a non-affiliate bank. Moreover, the broker-dealer's customers may not derive any significant protection from the reserve requirement in the event of the parent's insolvency."

SEC. "SECURITIES AND EXCHANGE COMMISSION 17 CFR Part 240 [Release No. 34-55431; File No. S7-08-07] RIN 3235-AJ85 Amendments to Financial Responsibility Rules for Broker-Dealers." Pages 10-11. Accessed 2012-05-16. <http://www.sec.gov/rules/proposed/2007/34-55431.pdf>.

[23] "Allocation of Customers' Fully Paid and Excess Margin Securities to Short Positions."

SEC. "SECURITIES AND EXCHANGE COMMISSION 17 CFR Part 240 [Release No. 34-55431; File No. S7-08-07] RIN 3235-AJ85 Amendments to Financial Responsibility Rules for Broker-Dealers." Page 15. Accessed 2012-05-16. <http://www.sec.gov/rules/proposed/2007/34-55431.pdf>.

[24] "The SEC proposes to amend Rule 15c3-3 by adding a new paragraph (j) that would make it unlawful for a broker-dealer to convert, invest, or otherwise transfer free credit balances except under three circumstances."

SEC. "SECURITIES AND EXCHANGE COMMISSION 17 CFR Part 240 [Release No. 34-55431; File No. S7-08-07] RIN 3235-AJ85 Amendments to Financial Responsibility Rules for Broker-Dealers." Page 19. Accessed 2012-05-16. <http://www.sec.gov/rules/proposed/2007/34-55431.pdf>.

[25] To receive protection under SIPA, a claimant must first qualify as a "customer" as that term is defined in the statute. Generally, a "customer" is any person who has (1) "a claim on account of securities received, acquired, or held by the [broker-dealer]," (2) "a claim against the [broker-dealer] arising out of sales or conversions of such securities" or (3) "deposited cash with the debtor for the purposes of purchasing securities." 15 U.S.C. 78lll(2). The definition of "security" in SIPA specifically excludes commodities and non-securities futures contracts (see 15 U.S.C. 78lll(14)) and, thus, a person with a claim for such assets would not meet the definition of "customer."

Accordingly, the SEC proposes an amendment to paragraph (a)(8) of Rule 15c3-3, which would clarify that funds held in a commodity account meeting the definition of a "proprietary account" under Commodity Exchange Act regulations are not to be included as "free credit balances" in the customer reserve formula.

The purpose behind the cash reserve requirements in Rule 15c3-3 is to require broker-dealers to hold sufficient funds with which to satisfy customer claims arising from securities (not commodities) transactions and, thereby, to minimize the need for a SIPA liquidation.

SEC. “SECURITIES AND EXCHANGE COMMISSION 17 CFR Part 240 [Release No. 34-55431; File No. S7-08-07] RIN 3235-AJ85 Amendments to Financial Responsibility Rules for Broker-Dealers.” Pages 26-27. Accessed 2012-05-16. < http://www.sec.gov/rules/proposed/2007/34-55431.pdf>.

[26] “Proprietary Accounts” under the Commodity Exchange Act. Generally a broker-dealer also registered as an FCM holding free credit balances in commodities accounts must not include funds in them as “free credit balances” when performing a customer reserve computation. These funds likely would not be protected in a SIPA proceeding because they are related to commodities transactions. So the purpose of 15c3-3 would not be served by treating funds held in commodities accounts (that are not segregated under CEA regulations) as “free credit balances.””

SEC. “SECURITIES AND EXCHANGE COMMISSION 17 CFR Part 240 [Release No. 34-55431; File No. S7-08-07] RIN 3235-AJ85 Amendments to Financial Responsibility Rules for Broker-Dealers.” Pages 26-27. Accessed 2012-05-16. < http://www.sec.gov/rules/proposed/2007/34-55431.pdf>.

“Holding Futures Positions in a Securities Portfolio Margin Account. A broker-dealer can combine securities and futures positions into the portfolio margin account. SIPA, however, only protects customer claims for securities and cash and specifically excludes from protection futures contracts that are not also securities.

See the Portfolio Margin Rules. The definition of “security” in SIPA includes a futures contract that also is a security; namely, a “security future” as defined in section 3(a)(55)(A) of the Exchange Act. See 15 U.S.C. 78lll(14).

This raises a question as to how futures positions in a portfolio margin account would be treated in a SIPA liquidation.”

Consequently, the SEC is proposing amendments to Rules 15c3-3 and 15c3-3a that are designed to provide the protections of Rule 15c3-3 and SIPA to futures positions in a securities account under the Portfolio Margin Rules. The SEC believes the proposed amendments designed to provide the protections of Rule 15c3-3 and SIPA to all positions in a securities account established under a SRO portfolio margin rule are warranted given that the futures positions in the account serve as hedges for the securities positions and, therefore, reduce the risk of the securities positions. The intermingled nature of the positions, margin or deposit, and the fact that the futures positions reduce the amount of margin necessary to carry the securities positions makes it highly practical to treat all the positions in accordance with the requirements of Rule 15c3-3 and, as part of the customer’s “net equity” in a SIPA liquidation.

SEC. “SECURITIES AND EXCHANGE COMMISSION 17 CFR Part 240 [Release No. 34-55431; File No. S7-08-07] RIN 3235-AJ85 Amendments to Financial Responsibility Rules for Broker-Dealers.” Pages 27-28, 30-31. Accessed 2012-05-16. < http://www.sec.gov/rules/proposed/2007/34-55431.pdf>.

[27] “Securities Lending and Borrowing and Repurchase/Reverse Repurchase Transactions.”

SEC. “SECURITIES AND EXCHANGE COMMISSION 17 CFR Part 240 [Release No. 34-55431; File No. S7-08-07] RIN 3235-AJ85 Amendments to Financial Responsibility Rules for Broker-Dealers.” Page 31. Accessed 2012-05-16. < http://www.sec.gov/rules/proposed/2007/34-55431.pdf>.

Securities and repurchase lending transactions whereby a broker-dealer lends customer property or its own property poses risks by complicating the segregation and net capital procedures. Broker-dealers must generally deduct from their net worth most unsecured receivables. Uncertainty as to whether broker-dealers are acting as principal or agent in a securities loan transaction raises concerns as to whether firms are taking required net capital charges related to their securities lending activities.

b. Future/commodity transactions. The CFTC also describes techniques for mitigating the challenges to segregation. For example, the Commodity Exchange Act requires that all customer property an FCM receives be segregated from and accounted for separately from the FCM's own funds. (CFTC Regulation 30.7 contains a related requirement for foreign futures and foreign options customer funds and exceptions for security futures funds held in securities accounts.) The FCM must obtain an acknowledgement from the depository which states that it has been informed that the account is a customer segregated account. An FCM

Under paragraph (c)(2)(iv)(B) of Rule 15c3-1, broker-dealers are required to deduct from net worth most unsecured receivables, including the amount that the market value of a securities loan exceeds the value of collateral obtained for the loan. Similarly, with respect to repo transactions, a broker-dealer obligated to resell securities must, in computing net capital, deduct the amount that the market value of the securities is less than the resale price. 17 CFR 240.15c3-1(c)(2)(iv)(F). A broker-dealer obligated to repurchase securities must, in computing net capital, deduct the amount that the market value of the securities is greater than the repurchase price to the extent the excess is greater than certain percentages. 17 CFR 240.15c3-1(c)(2)(iv)(F).

A broker-dealer might not take the required charges on the theory that it was arranging the loans as agent, rather than principal, notwithstanding the fact that there was no express disclaimer of principal liability.

The SEC is proposing two amendments designed to improve regulatory oversight of securities lending and repo transactions. The first proposal would clarify that broker-dealers providing securities lending and borrowing settlement services are assumed, for purposes of the rule, to be acting as principals and are subject to applicable capital deductions, unless the broker-dealer takes certain steps to disclaim principal liability with the transaction. [Standard master securities loan agreements (including the annexes thereto) commonly used by the parties to a securities lending transaction contain similar provisions for establishing agent (as opposed to principal) status in a securities lending and borrowing transaction. See, e.g., 2000 Master Securities Loan Agreement, Annex I, published by The Bond Market Association.] The second proposal would add a paragraph (c)(5) to Rule 17a-11, which would require broker-dealers to notify the SEC whenever the total amount of money payable against all securities loaned or subject to a repurchase agreement, or the total contract value of all securities borrowed or subject to a reverse repurchase agreement exceeds 2,500 percent of tentative net capital (excluding government securities).

"The failure of a broker-dealer engaged in significant securities lending caused losses to the borrowing broker-dealers and to other firms to whom those broker-dealers re-lent the borrowed securities."

See, e.g., Nomura v. E*Trade, 280 F.Supp. 2d 184 (S.D.N.Y. 2003).

"In subsequent litigation, disputes have arisen as to whether certain of these broker-dealers were acting as principals or agents."

See id.

SEC. "SECURITIES AND EXCHANGE COMMISSION 17 CFR Part 240 [Release No. 34-55431; File No. S7-08-07] RIN 3235-AJ85 Amendments to Financial Responsibility Rules for Broker-Dealers." Pages 33-34. Accessed 2012-05-16. <http://www.sec.gov/rules/proposed/2007/34-55431.pdf>.

may contribute its own funds to a customer-segregated account in order to ensure that [the customer property] remains properly segregated.[28] Its books must at all times reflect the amount of its interest in the segregated account. (This ability to inject property funds into a customer account as a cushion can lead to confusion and problems, as in the MF Global case.) The CFTC requires an FCM to notify it and the self-regulatory organization ("SRO") of shortfalls in the required segregated accounts reports identifying investment of funds, carrying brokers and deposit of segregation computations, SROs to audit firms, and DCOs that acknowledge that they have received customer accounts.[29,30]

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[28] The recent theories for the misplacing of MF Global Funds is that (pursuant to the rule permitting an FCM to contribute funds to a customer account) MF Global tried to transfer proprietary funds to meet its own obligations and inadvertently exceeded its funds in the account. Instead, MF Global withdrew and transferred customer money.

[29] 17 CFR 1.23

[30] In addition, an FCM must notify the CFTC [17 CFR 1.12(h)] and its SRO immediately whenever it knows or should know that the total amount of funds on deposit in segregated accounts is less than the amount required to be held in segregation.

An FCM's designated SRO conducts periodic audits of FCMs and, in connection with such audits, confirms that customer funds are being held in properly designated accounts and that the depository has provided the FCM with a signed acknowledgment letter." [Futures Industry Association. "Protection of Customer Funds – Frequently Asked Questions." Accessed 2012-04-22. <http://www.futuresindustry.org/downloads/PCF-FAQs.PDF>.]

Each day an FCM must make a formal segregation computation. [17 CFR 1.32] This computation must detail the amount of customer funds required to be in segregated accounts, the amount of funds in segregated accounts, and the FCM's residual interest in the funds on deposit. This calculation must be completed by noon of the following business day.

FCMs, for which the National Futures Association ("NFA") is designated a self regulatory organization, that hold exchange traded futures customer funds must file the Segregated Investment Detail Report ("SIDR") on a monthly basis as of the last business day of the month. This report requires an FCM to provide a detailed breakdown of an FCM's investment of customer funds and identify the carrying brokers and other depositories holding these funds. The SIDR must be filed monthly with NFA by noon on the business day following the last business day of the month. In addition to the monthly report, a firm is also required to file a SIDR when there is a change of 20% or more in any reported balance from the date of the last SIDR. This report must be filed by noon on the business day after the change occurs.

Any FCM that carries accounts of foreign futures or foreign options customers (i.e., US customers trading futures or options on foreign exchanges) must maintain, in a separate account, funds sufficient to satisfy its obligations to those customers. There are also segregation requirements for the secured amount. The requirements include separate accounting, daily computation, recordkeeping, and acceptability of investments and depositories." [National Futures Association. "NFA Regulatory Requirements. For FCMs, IBs, CPOs, and CTAs. January 2012

> On July 10, the CFTC announced it had filed a complaint against "Peregrine Financial Group Inc. ("PFG"), a registered futures commission merchant, and its owner… The complaint alleges that PFG and [its owner] committed fraud by misappropriating customer funds, violated customer fund segregation laws, and made false statements in financial statements filed with the Commission… According to the complaint, in July 2012 during an NFA audit, PFG falsely represented that it held in excess of $220 million of customer funds when in fact it held approximately $5.1 million.
>
> The commission's action alleges that from at least February 2012 through the present, PFG and [its owner] failed to maintain adequate customer funds in segregated accounts… The complaint further alleges that defendants made false statements in filings required by the Commission regarding funds held in segregation for customers trading on US Exchanges.
>
> According to the complaint, [PFG's owner] attempted to commit suicide yesterday, July 9, 2012. In the aftermath of that incident, the staff of the NFA

Revisions: Updated to reflect amendments to anti-money laundering regulations." Pages 27-28. Accessed 2012-03-30.<http://www.nfa.futures.org/nfa-compliance/publication-library/regulatory-requirements-guide.pdf>.]

In accordance with Commission Rule 1.20, each account holding segregated funds or collateral must be properly titled to identify it as holding customer funds or collateral and segregated. Except as noted below, customer funds may not be commingled with the funds of any other person, including (and in particular) the depositing FCM. Each depository is required to provide the depositing FCM with a written acknowledgment that the depository was informed that such funds belong to futures customers. Among other representations, the depository must acknowledge that it cannot use any portion of customer funds to satisfy any obligations that the FCM may owe the depository.

An FCM must calculate daily the amount of funds they are required to hold in segregation, the amount of funds that are actually held in segregated accounts, and the FCM's residual interest, defined below, in the segregated account.[17 CFR 1.32]

received information that [the PFG owner] may have falsified certain bank records."[31]

c. Newly regulated over the counter ("OTC") clearable swaps. The Dodd-Frank Act reinforces the concept of proprietary versus customer property segregation in the recently regulated area of cleared swaps by requiring an FCM to separate, segregate, and identify customer collateral separate from its own property and, with certain exceptions, the property of other customers. Moreover, a DCO may not treat collateral posted by an FCM as belonging to anyone other than the customer. The newly adopted rules governing the treatment of the cleared swaps customer collateral account incorporate by reference many of the rules governing the customer segregated funds account including the rules discussed above. Therefore, an FCM must comply with these rules in connection with the cleared swaps customer collateral account.

Different Concepts of Segregation Based on Types of Regulated Entities, Locations, Products, Transactions, and Purposes

1. Different products/transactions involve different segregation and investment rules. A customer's rights to property vary depending on whether the transaction/product is a security, OTC derivative, listed derivative, secured loan, repurchase agreement, etc., or when the transaction involves margin or the pledging of funds/property as collateral.

   Different regulatory regimes or business practices may apply to different products/transactions. For example, FCMs may maintain up to three different types of

[31] CFTC. "CFTC Files Complaint Against Peregrine Financial Group, Inc. and Russell R. Wasendorf, Sr. Alleging Fraud, Misappropriation of Customer Funds, Violation of Customer Segregation Laws, and Making False Statements." <http://www.cftc.gov/PressRoom/PressReleases/pr6300-12>. Accessed 2012-07-17.

accounts for customers depending on the products a customer trades: (1) a customer segregated funds account for customers that trade futures listed on US futures exchanges; (2) a foreign futures and foreign options secured amount account for customers that trade futures and options on futures listed on foreign boards of trade; and (3) a sequestered account for customers trading swaps that are cleared on a DCO registered with the CFTC.

The requirement to maintain these separate accounts reflects the different risks posed by the different products. Cash, securities, and other collateral (collectively, property) required to be held in one account may not be commingled with property required to be held in another account, except as the CFTC may permit by order.[32]

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[32] a. Futures customer segregated funds. Property that customers deposit with an FCM, or that are otherwise required to be held for the benefit of customers, to margin futures and options on futures contracts traded on futures markets located in the US, (i.e., designated contract markets), are held in a customer segregated funds account. [17 CFR 1.20 (CFTC)] Customer funds held in the customer segregated funds account may not be used to meet the obligations of the FCM or any other person including another customer.

All futures customer segregated funds may be commingled in a single account at a bank or trust company, a DCO, or another FCM. Such account, (i.e., an omnibus account), must be properly titled to make clear that the funds belong to, and are being held for the benefit of, the FCM's customers.

b. Foreign futures and foreign option secured amount. Funds that customers deposit with an FCM, or that are otherwise required to be held for the benefit of customers, to margin futures and options on futures contracts traded on foreign boards of trade are held in a foreign futures and foreign options secured amount account. [17 CFR 30.7 (CFTC)] Funds required to be held in the foreign futures and foreign options secured amount account may be commingled in an omnibus account with: (1) a bank or trust company located within the US; (2) a bank or trust company located outside the US that has in excess of $1 billion in regulatory capital; (3) an FCM; (4) a DCO; (5) a foreign broker; or (6) such DCO's or foreign broker's designated depositories.

The funds held in the foreign futures and foreign options secured amount account must be at least sufficient to cover or satisfy all of an FCM's obligations to its foreign futures and foreign options customers.

The foreign futures and foreign options secured amount required to be set aside must generally equal for each account at least the lesser of: (1) the net liquidating equity plus the market value of any securities held in the customer's account; or (2) margin required, plus or minus the unrealized gain or loss on futures positions, plus long option value, minus short option value.

c. Cleared swaps customer sequestered account for collateral. Funds deposited with an FCM, or otherwise required to be held for the benefit of customers, to margin swaps cleared through a registered DCO are currently held in a sequestered account in accordance with applicable DCO rules. Such funds may currently be held in the

Broker-dealers must also generally segregate customer property from their own and may also comingle it with other customer property.

Banks may hold property as trustee or custodian separate from their own assets and may comingle them for certain investment or other administrative purposes.

Introduction of Parties into a Transaction May Change Risk Profile of Segregation

Adding any third party to a transaction increases the risks to identifying and segregating customer property. For example, a financial firm must have possession or control of customer property, but a financial firm may use customer securities for securities lending, securities repurchase arrangements, and rehypothecation, thereby introducing a third party. The right to "reuse" customer property is subject to certain computing, record keeping, collateral, disclosure, and valuation requirements.[33] Moreover, a broker-dealer may further introduce new counterparties and new risks both by introducing clearinghouses and custodians.

Regulations or industry practice may dictate the involvement of non-affiliated third parties (such as custodians or clearinghouses) to avoid conflicts of interest, to introduce an element of safety that results from more parties watching each other, or to "securitize" risk. Sometimes these risk mitigation techniques raise other risks – such as impeding full segregation. For example, a clearinghouse securitizes risk in a transaction between two customers, each of whom is represented by a financial firm, by becoming the counterparty to each of the financial firms in

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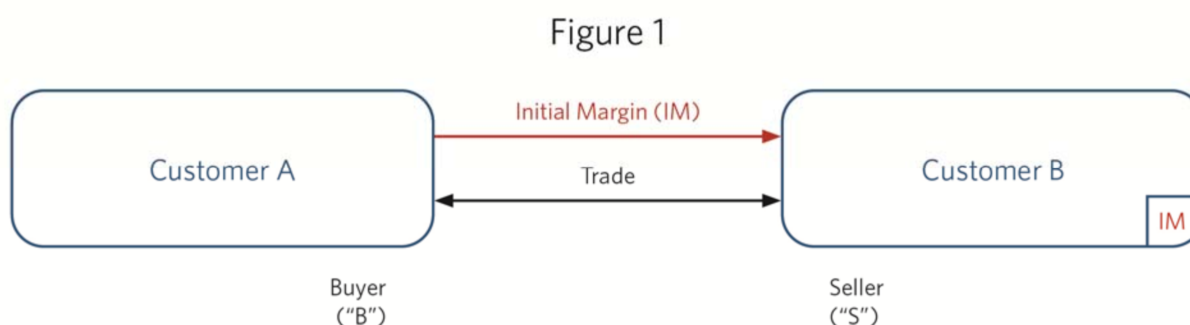
foreign futures and foreign options secured amount account. Upon the effective date of the CFTC's recently adopted Part 22 rules (November 8, 2012), funds posted for margin swaps cleared through a DCO will be held in a cleared swaps customer collateral account. Funds required to be held in a cleared swaps customer collateral account may be commingled in an omnibus account at a bank or trust company, a DCO, or another FCM. However, as noted above, such funds may not be commingled with funds required to be held in the customer segregated funds account, except pursuant to an order issued by the CFTC." [Futures Industry Association. "Protection of Customer Funds – Frequently Asked Questions." Accessed 2012-04-22. <http://www.futuresindustry.org/downloads/PCF-FAQs.PDF>.]

a transaction. The customer's risk has thus been spread among the investors/members of the clearinghouse rather than concentrated in the original counterparty's financial firm.

The following diagrams and text illustrate the operational risks as more counterparties are introduced.

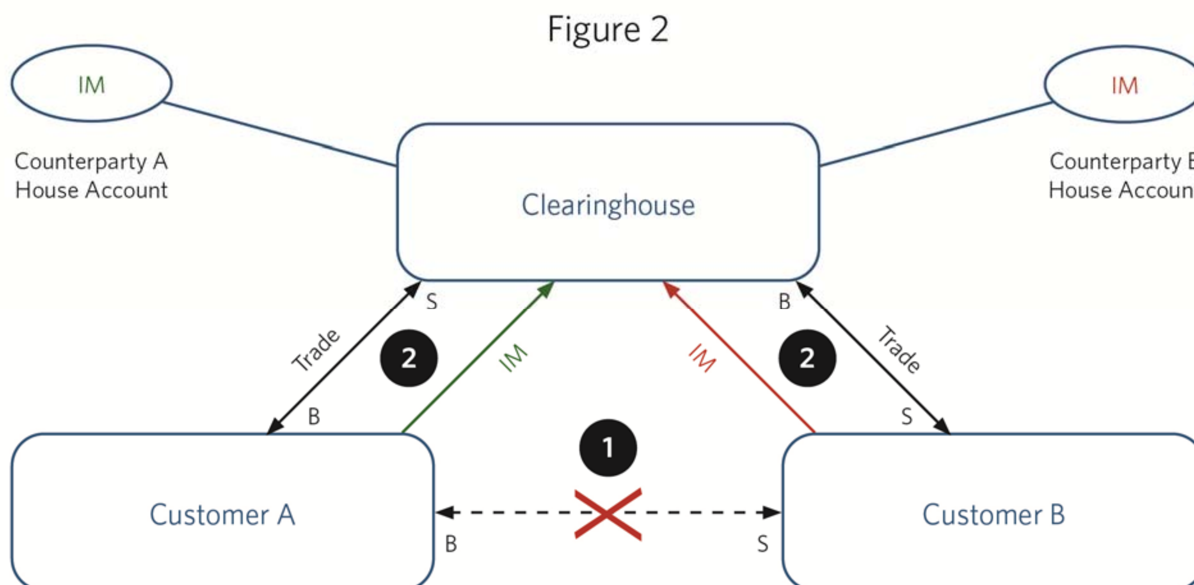
1. <u>Buyer and seller.</u> Customer A, as buyer, may purchase a product from customer B, as seller. Figure 1 illustrates this process:



   Generally, a simple bilateral transaction like Figure 1 does raise the risk that one customer may not segregate the property of its counterparty so that: (1) creditors of the non-segregating party may pursue the assets of the non-segregating party; and/or (2) operational confusion impedes the ability of the non-segregating party to return its counterparties property.

2. <u>Introduction of a clearinghouse.</u> The original buyer (Customer A) and an original seller (customer B) execute a swap (transaction) to be cleared by a clearinghouse. Once the swap is cleared, the original trading parties maintain their original exposure with respect to the underlying trade (i.e., each trading party maintains its position as either a seller or a buyer), but each faces the clearinghouse directly and no longer has exposure to each

other. In turn, the clearinghouse becomes the buyer to the original seller and the seller to the original buyer. Figure 2 illustrates this process:



If one of the original trading parties defaults, the clearinghouse is contractually obligated to pay all amounts owed to the non-defaulting party in respect of the underlying trades.

Clearing also alters margin posting requirements. In a bilateral trading market, parties freely negotiate which party will be required to post collateral, under which circumstances, and how much collateral will be required. In contrast, clearinghouses require each trading party to post both initial margin and variation margin.

The introduction of a clearinghouse generally reduces the risk that a customer, for example, might not segregate the property of the other customer. Generally, a clearing house should segregate. But here again there is the risk that the clearinghouse has not properly segregated: (1) customer property from proprietary property; and (2) one customer's property from another's.

a. Protections/risks raised by clearinghouses. The introduction of clearinghouses into securities and derivatives transactions is intended to minimize certain risks although it also introduces other risks. In a transaction involving a clearinghouse, financial firm A, acting on behalf of customer A, and financial firm B, acting on behalf of customer B, pass on to the clearinghouse the obligations between them.

"As the clearinghouse concentrates the risk of settlement failures into itself and is able to isolate the effects of a failure of a market participant, it also needs to be properly managed and well-capitalized in order to ensure its survival in the event of a significant adverse event, such as a large clearing firm defaulting or a market crash.

Many clearinghouses are capitalized with collateral from their clearing members. In the event of a settlement failure, the clearing member may be declared to be in default and clearinghouse default procedures may be utilized, which may include the orderly liquidation of the defaulting clearing member's positions and collateral. In the event of a significant clearing firm failure, the clearinghouse may draw on its guarantee fund in order to settle trades on behalf of the failed clearing firm."[34]

Some might find comfort in this spreading of risk by using a clearinghouse; some believe the risk is passed on to too small or consolidated a group of members of clearinghouses. Others believe that this spreading of risk provides a false sense of security to counterparties and enables the use of smaller less well managed

[34] Wikipedia. "Clearinghouse." Accessed 2012-03-30. <http://en.wikipedia.org/wiki/Clearing_house_(finance)>.

financial firms which do not have the financial or risk management resources to handle the exposure.

While the presence of a clearinghouse may reduce (or shift) financial firm counterparty risk, the customer is exposed to some additional risks: (1) risks that the clearinghouse does not perform properly; (2) operational risks that always occurs between two counterparties; (3) the risk that a clearinghouse uses its own rules or local law; and (4) fellow customer risk (the risk that the clearinghouse may satisfy obligations of defaulting customer A and of defaulting financial firm/clearing member A to the clearinghouse by taking the property of Customer B).

"Another category of clearinghouse safeguard consists of emergency procedures and financial back-up arrangements once default by a clearinghouse member has occurred. The principles applied here are generally those of risk-control (immediate close out of the defaulting member's proprietary positions) and risk segregation [or porting] (transferring customer positions and funds from the defaulting member to another clearing member). Where a defaulting clearing member's margin is insufficient to satisfy the member's obligations, the principle of loss-spreading applies, which may involve reliance on ex ante security deposits paid in by the clearing membership in the form of a guarantee fund, ex post assessments made against clearing members, and back-up insurance arrangements when losses exceed all other available financial resources."[35]

[35] Richard Dale. "Risk Management in US Derivatives Clearinghouses." *Essays in International Financial & Economic Law*. No. 14, 199. (11-12)

b. Fellow customer risk at a clearinghouse. Conceptually and practically, segregation of customer funds from proprietary funds is easy when compared with keeping customer funds from other customer funds. The segregation of the funds of Customer A and Customer B may be complicated especially when all customer funds are aggregated and then reinvested or held elsewhere outside of the financial firm. Customers may not be conscious that they have accepted fellow customer risk. "Fellow customer risk is the risk that one or more customers of a financial firm will default on [its] obligations to the financial firm and that such loss will be so great that the financial firm, in turn, will default on its obligations to a DCO or to a clearing financial firm that carries the financial firm's customer account."[36]

The last risk a customer normally considers is the possibility that a customer's property may not be recovered because of a default of the financial firm's other customers. Fellow customer risk is ubiquitous. Whenever a financial firm, indeed any obligor, owes customer A money, customer A is exposed to the possibility that the firm's/obligor's inability to collect from its other customers reduces its ability to pay customer A. In the context of financial services, "fellow customer risk" generally refers to a narrower group of scenarios where (for a variety of ways, purposes, and parties) customer A's property is not clearly segregated from customer B's property.

As noted above, a financial firm may entrust customer property to a clearinghouse, custodian or, other financial firm as long as it takes certain steps

[36] Futures Industry Association. "Protection of Customer Funds – Frequently Asked Questions." Accessed 2012-04-22. <http://www.futuresindustry.org/downloads/PCF-FAQs.PDF>.

to ensure protection of such property. Often, the customer's property is held in an omnibus account, and in such cases, a customer may be exposed to fellow customer risk. Customer A's property may be at risk if Customer B and the financial firm fail to meet each of their obligations to the third party and the third party has the contractual right to use the property in the customer account. Whenever a financial firm uses a clearinghouse for clearing a securities transaction, a registered futures transaction, or a Dodd-Frank clearing required derivatives transaction, the clearinghouse may have the right to access the collateral of non-defaulting customers when a customer fails to pay its obligations and the clearing member/financial firm does not have sufficient assets to post to the FCM. In this case, the non-defaulting customers of the defaulting financial firm would be exposed to loss. Under current rules applicable to FCMs, for example, a DCO may use all customer collateral in a clearing member's customer account to satisfy an FCM/clearing member's obligations.

A few clearinghouses segregate all accounts and for this purpose set up individual customer accounts which cannot be commingled. Some others allow clearing members' proprietary accounts and customer accounts to be combined into a single account. However, the most common regime is one in which customer accounts are commingled in a single account but segregated[37] from clearing

[37] 'Segregation" in this context may refer merely to a record-keeping function, where no title or rights to assets are conferred on a third party, or to a physical separation of assets that has the effect of conferring such rights. In general, segregated accounts maintained by a clearinghouse are a matter of record-keeping, whereas at the clearing member level physical segregation of assets may be required. For instance, under the rules of the London Clearinghouse ("LCH") monies that would be payable by LCH to a member in respect of the member's segregated customer's account cannot be used by LCH to offset losses. To this extent segregated customer funds are protected. However, if LCH were to become insolvent, these funds would be available to meet the claims of general creditors. Contrast the situation of clearing members who, under UK rules, must physically segregate customer monies and hold them in a customer bank account on trust for such customers. Richard Dale. "Risk Management in US Derivatives Clearinghouses." *Essays in International Financial & Economic Law*. No. 14, 199. (11-12)

members' proprietary positions. Under this last arrangement customers are insulated from the trading risks incurred by clearing members since customer funds/margins cannot be used to meet the members' margin requirements. Clearing members, on the other hand, are responsible for the margin obligations of their customers.[38]

i. Fellow customer risk in the context of futures. CFTC Rule 1.23 prohibits an FCM from using the funds of one customer to meet the obligations of another customer. Rather, an FCM must use its own funds to meet a defaulting customer's obligations to a DCO or clearing FCM.

   If the loss is so great that, notwithstanding the application of the FCM's own funds, there is a shortfall in the amount of customer funds required to be held in segregation, the FCM will default and likely be placed into bankruptcy. In these circumstances, the Bankruptcy Code provides that non-defaulting customers will share in any shortfall, pro rata. A shortfall in customer segregated funds may also make the transfer of the accounts of non-defaulting customers to another FCM (i.e., porting) more difficult. Customers are exposed to fellow customer risk in all markets for which an FCM holds customer funds, (i.e., futures and options on futures traded on US exchanges, futures and options on futures contracts traded on foreign boards of trade, and cleared swaps).

[38] Derivatives exchanges typically operate on a principal to principal basis, meaning that the clearinghouse has no contractual relationship with clearing members' customers, but rather looks to the clearing member for performance of its contracts.

ii. Fellow customer risk in the context of Dodd-Frank clearing required swaps. The CFTC's recently-adopted rules governing cleared swaps customer collateral are intended to provide cleared swaps customers enhanced protection from fellow customer risk.[39]

The CFTC adopted the approach of "legal segregation with commingling" (so called "Part 22" Rules) in dealing with new Dodd-Frank CFTC clearable swaps after considering four ways to address fellow customer risk raised by a clearinghouse. (Note that for futures, the current model is where the customer margin is held by the FCM in an omnibus account segregated from an FCM's creditors but available to the DCO to satisfy margin obligations in the event the FCM does not meet the failed margin requirements of another customer ("fellow customer risk") (called "Baseline Model").) The CFTC then considered four models:

1. Baseline Model (used for FCM's in the futures context);
2. "Moving Customers to the Back of the Waterfall": this is also the equivalent of the current futures model with client margin subject to fellow customer risk only after exhaustion of the DCO's other financial safeguards;
3. "Legal Segregation with Commingling": this is also the equivalent of the current futures model but without fellow customer risk; and
4. "Full Physical Segregation": this would differ from the current futures model as customer margin would be held in individual

[39] Futures Industry Association. "Protection of Customer Funds – Frequently Asked Questions." Accessed 2012-04-22. <http://www.futuresindustry.org/downloads/PCF-FAQs.PDF>.

customer accounts (either at the FCM or with a tri-party custodian) without fellow customer risk.

As with the futures customer segregated funds account (which does not protect against fellow customer risk), the Part 22 rules permit an FCM to maintain cleared swaps customer positions and collateral in an omnibus account, on its own books and at the relevant DCO. As an enhancement to the current futures approach, the carrying FCM, the clearinghouse, and the DCO will know the customer identity, positions, and margin to protect against fellow customer risk.[40]

The Part 22 rules do not protect cleared swaps customer's shortfalls in the cleared swaps customer collateral account following the bankruptcy of an FCM.[41]

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[40] The FCM carrying the customer's account must advise the clearing FCM (if different) of the identity of each customer within the omnibus account, the portfolio of positions held by each customer and the margin required to support such positions. The clearing FCM must provide the same information to the DCO that clears the positions. In the event of the default of an FCM caused by a default of one or more customers, the defaulting FCM must notify the clearing FCM (if different), and the clearing FCM must notify the DCO (if the CM has defaulted), of the identity of the cleared swaps customer(s) that caused the default.

Upon the default of an FCM, the Part 22 rules prohibit the DCO from applying funds in a cleared swaps customer omnibus account attributable to non-defaulting customers to meet the shortfall owing to the DCO in connection with a defaulting customer. In contrast to this provision of the Part 22 rules, the CFTC's rules governing the customer segregated funds account do not prohibit a DCO from using the funds of non-defaulting customers held by the DCO to meet the shortfall owing to the DCO arising from the bankruptcy of a clearing FCM.

[41] "For example, the rules would not protect such customers: (1) if the bankrupt FCM's books and records are inaccurate; (2) in the event of a shortfall in the cleared swaps customer collateral account arising from FCM fraud or mismanagement; or (3) in the event a bankruptcy trustee incurs losses in liquidating collateral held in the cleared swaps customer collateral account in which the FCM had invested in accordance with CFTC Rule 1.25.

The bankruptcy code provides that non-defaulting public customers of an FCM will share in any shortfall in customer segregated funds, pro rata, and, consequently, under the existing segregation models, individually segregated accounts would not appear to provide customers with greater protection if the FCM were to fail. In adopting rules for the protection of cleared swaps customer collateral, the CFTC determined that any increased protection that might be provided by individually segregated accounts would be minimal."

The industry argues that “from an operational perspective, individual segregation would be difficult and expensive to implement, thereby exposing FCMs to increased operational risk. FCMs would need to establish individual accounts at each depository or DCO at which customer funds are held. DCOs, in turn, would be required to maintain individual accounts for each customer. A DCO would need authority to withdraw funds from each account daily, as necessary to meet the customer’s margin obligations. To the extent a customer clears through more than one DCO, a separate account would be required for each DCO. A customer’s cost of trading likely would increase significantly, as there potentially would be many individual transfers of funds on behalf of each customer between the customer account and each DCO at which the customer maintains open positions.”[42]

Fellow customer risk may also arise from how a clearing firm identifies (or does not identify) customer property.[43]

iii. <u>Fellow customer risk in the context of securities transactions.</u> Similar segregation issues arise in the context of securities transactions. For example, “in the cash markets served by the National Securities Clearing Corporation (“NSCC”), this identification [of customer and proprietary assets] occurs on the books and records of the members, and not on

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Futures Industry Association. “Protection of Customer Funds – Frequently Asked Questions.” Accessed 2012-04-22. <http://www.futuresindustry.org/downloads/PCF-FAQs.PDF>.

[42] Futures Industry Association. “Protection of Customer Funds – Frequently Asked Questions.” Accessed 2012-04-22. <http://www.futuresindustry.org/downloads/PCF-FAQs.PDF>.

[43] IOSCO

NSCC's books and records."[44] The result is that if a clearing member defaulted because of a customer's default, the clearinghouse would assess non-defaulting "fellow" customer assets in the account of the defaulting clearing member. Eurex's menu of options for individual clearing models for non-clearing members offers complete segregation from other customers and the clearing member accounts.[45]

In any case, the introduction of a DCO or custodian in a transaction, whether by choice, market, or law raises more issues to consider about

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[44] National Securities Clearing Corporation. "Assessment of Compliance with the CPSS/IOSCO Recommendations for Central Counterparties." 2011-11-14. 31.

[45] Eurex Clearing's Solutions: "As it is intended by EMIR clients of clearing members will have the option as to how their position and margin collateral (cash and securities) is held and posted by their clearing member at Eurex Clearing, depending on each individual client's needs. In the event of a clearing member's default all client positions with the defaulting clearing member may be transferred to another clearing member. Clearing members and their clients can choose:

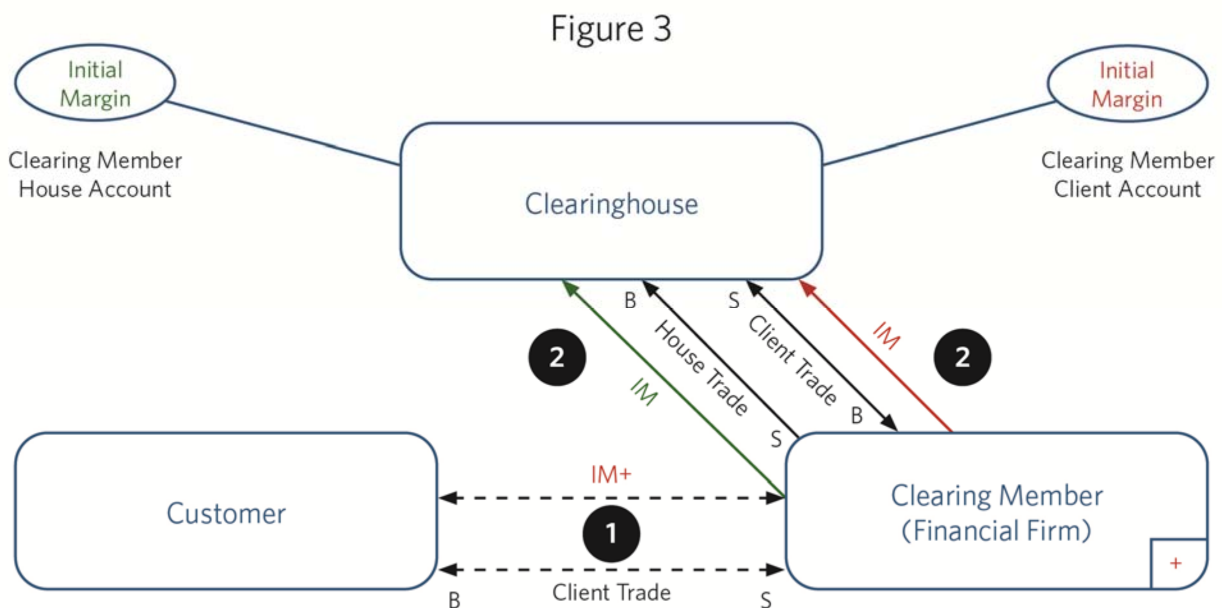
- Individual Clearing Model for Non-clearing members ("NCM"s)
  - Maximum protection is achieved for Non-CMs who opt for the Individual Segregation Model.
  - Positions and margin collateral of an individually segregated NCM are held in dedicated, individual accounts and separately booked at Clearinghouse level. Hence, they are completely ring-fenced from the clearing member's or other client's positions and margin collateral.
  - Seamless and timely portability of NCM positions and margin collateral is achieved through a close-out netting mechanism in case of a clearing member's default. Positions against the defaulting clearing member will be terminated and subsequently re-opened at a new clearing member.
- Individual Clearing Model for Registered Customers
  - This solution includes all the benefits of the Individual Clearing Model for NCMs and is available to customers who are not trading members[45] of Eurex Clearing cleared markets.[45]
  - Positions and assets of the Registered Customer will be held in segregated accounts at clearinghouse level. Furthermore, Registered Customers in listed markets will be able to monitor their positions and collateral through reports from their clearing member, while Registered Customers for the OTC IRS and OTC CDS market will be able to monitor their positions and collateral directly via EurexOTC Clear GUI (web based).
- Omnibus Segregation Model
  - In a final stage we will introduce omnibus segregation, the general principles are:
    - Clearing member's clients that choose this clearing model will have their positions and margin collateral held in one separate omnibus position and omnibus collateral account established at the clearing member level and separately booked at the clearinghouse level. Therefore all collateral remains completely segregated from the clearing member and other clients -not opted for a segregation model- positions and margin collateral.

Portability of omnibus positions requires consent of all involved parties."

Eurex Clearing. "Client Asset Protection: Ensuring Highest Protection for Our Customers." Accessed 2012-03-06. <http://www.eurexclearing.com/risk/cap_en.html>.

how the DCO or custodian segregates, identifies, or reviews the customer property including whether there is co-customer risk.

3. Introduction of a clearing member. A customer may enter into a trade with a dealer that will also act as the customer's clearing member and clear the trade on the customer's behalf with a clearinghouse. Once the customer and the clearing member have traded, the clearing member submits the trade for clearing to the clearinghouse. The original trade is replaced with two trades between the clearing member and the clearinghouse: the client trade with respect to which the clearing member acts as agent on behalf of the customer and proprietary house trade with respect to which the clearing member acts as principal (and thereby takes the other side of the trade). Once the trade has been cleared, both the customer and the clearing member maintain their original positions with respect to the underlying trade but they now face the clearinghouse. Figure 3 illustrates this process (adopting the same hypothetical as in Figure 1 where a customer buys a derivatives product from its clearing member):



The introduction of a clearing member financial firm complicates the ability to protect and identify customer property because the clearing member may not maintain proper records, and customer property at the clearinghouse may be subject to the fellow customer risk that a customer of the clearing member may default and the clearinghouse would use the non-defaulting customer property to satisfy the defaulting clearing member's debts to the clearinghouse.

a. How are customer trades and property protected in the event of a default by a financial firm that is a clearing member? Two interrelated mechanisms, portability of trades and segregation of collateral, are intended to mitigate the impact of a default by a customer's clearing member.

   Portability of trades enables a customer to move (port) trades from one clearing member to another clearing member that has agreed to accept those positions during a limited time period during which the clearinghouse may effectuate porting, depending on how easily margin posted by such customer is identifiable (i.e., how it has been segregated) at the clearinghouse. Prior to a default, clearing members are typically required by law (banking, securities, commodities, and bankruptcy laws) to promptly transfer a customer's trades to another clearing member as designated by the customer. These issues highlight the importance of having relationships in place with more than one clearing member.

   Commingling customers in an omnibus account impedes the portability process because it is harder to trace the collateral posted by the individual customer but it also creates fellow customer risk. Consequently, if a customer defaults and there is a deficit in such customer's margin account balance at the clearinghouse and

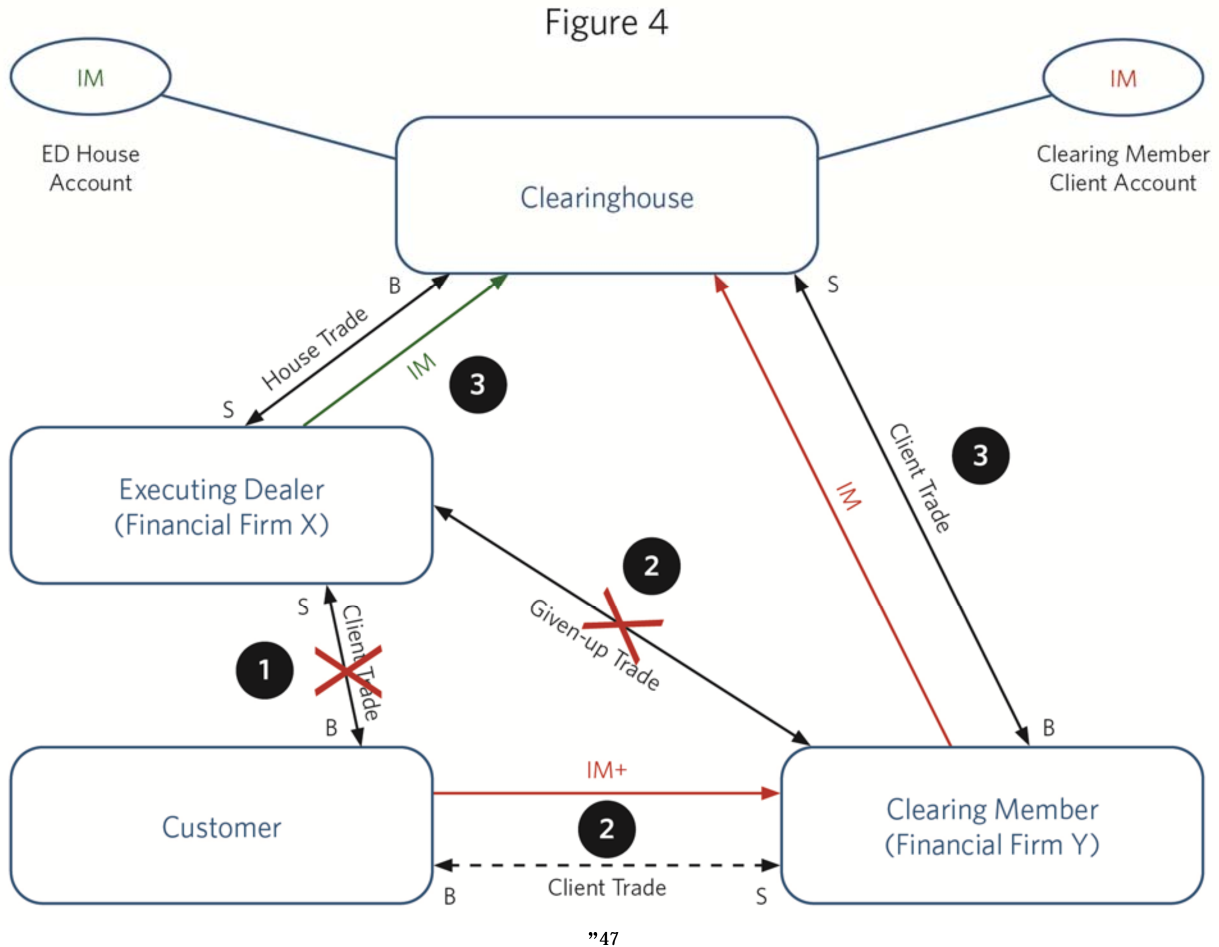
the clearing member in turn defaults because it does not have sufficient resources to cover such deficit, other (fellow) customers may face the risk that the clearinghouse uses the collateral posted by such fellow customers to cover for a deficiency.

"Portability may be facilitated and fellow customer risk mitigated or eliminated by appropriately segregating margin posted by customers. A complete segregation model where customer margin would be held in bankruptcy remote accounts would provide a high degree of protection. However, it would be more costly and probably also affect customer incentives to monitor the creditworthiness of their clearing members. The model recently proposed by the CFTC contemplates a complete legal segregation under which clearinghouses would be permitted to commingle customer collateral in one account but would only have recourse to the collateral posted by a defaulting customer if both such customer and its clearing member simultaneously default."[46]

4. Introduction of an executing firm. A customer may want to enter into a transaction with a dealer that is not also acting as the customer's designated clearing member. The dealer in such a case is typically referred to as an executing broker. In this scenario, once the customer and the executing broker have traded, pursuant to a give-up agreement, the executing broker and the customer's clearing member, acting as an intermediary on behalf of the customer, enter into the trade (subject to the trade being accepted for clearing by the clearinghouse). The executing broker and the clearing member then submit the trade for clearing to the clearinghouse. Both the executing broker and the customer (through its clearing member) will then face the clearinghouse and post initial

[46] The Hedge Fund Law Report. Volume 4, Number 24, July 24, 2011.

margin that will be held in separate accounts at the clearinghouse as described above. Figure 4 illustrates this process:



"[47]

The introduction of an executing dealer complicates the identification and protection of customer property because again accurate recordkeeping needs to take place at two financial firms (the executing dealer and the clearing member) and at the clearinghouse.

5. Introduction of custodians. Primarily for safety and to ensure that an objective third party with an independent and robust risk management system is used, a third-party custodian or central securities depository may be introduced into the process.

[47] The Hedge Fund Law Report. Volume 4, Number 24, July 24, 2011.

a. Custodians in securities transactions. For example, in the securities context, "a Central Securities Depository ("CSD") is an organization holding securities either in certificated or uncertificated (dematerialized) form, to enable book-entry transfer of securities. In some cases these organizations also carry out centralized comparison and transaction processing such as clearing and settlement of securities. The physical securities may be immobilized by the depository, or securities may be dematerialized (so that they exist only as electronic records)."[48,49] Again, however, the introduction of another entity also increases operational risk.[50,51]

b. Custodians in newly regulated cleared swaps transactions. In the swaps context, the International Swaps Dealer Association ("ISDA") has analyzed a range of alternative custodial or holding arrangements that are available to firms to negotiate depending on risks, costs, appetites, and regulatory constraints. This

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[48] Wikipedia. "Central securities depository." Accessed 2012-03-30. <http://en.wikipedia.org/wiki/Central_securities_depository>.

[49] Depositories may offer services such as safekeeping, securities, deposits and withdrawals for transfer, interaction with transfer agents, or insurers for transfer and exchanges, dividend, interest and principal processing, securities lending and borrowing, matching, repo settlement, and pledges.

[50] Wikipedia. "Custodian bank." Accessed 2012-03-30. <http://en.wikipedia.org/wiki/Custodian_bank>.

[51] The role of a custodian in such a case would be to: hold in safekeeping assets/securities such as stocks, bonds, commodities such as precious metals and currency (cash), domestic and foreign; arrange settlement of any purchases and sales and deliveries in/out of such securities and currency; collect information on and income from such assets (dividends in the case of stocks/equities and coupons (interest payments) in the case of bonds) and administer related tax withholding documents and foreign tax reclamation; administer voluntary and involuntary corporate actions on securities held such as stock dividends, splits, business combinations (mergers), tender offers, bond calls, etc.; provide information on the securities and their issuers such as annual general meetings and related proxies; maintain currency/cash bank accounts, effect deposits and withdrawals and manage other cash transactions; perform foreign exchange transactions; often perform additional services for particular clients such as mutual funds; examples include fund accounting, administration, legal, compliance, and tax support services; and provide regular and special reporting on any or all their activities to their clients or authorized third parties such as MAIC Trust Account services for mergers & acquisitions payments.

demonstrates the shifting and possible mitigation of risk in the protection of property.[52]

To protect counterparties' collateral, proposed Dodd-Frank regulations – pending full implementation of the reforms mandated by Section 724(c) for uncleared swaps and the analogous requirement for uncleared security-based swaps contained in Section 763(d) of the Dodd-Frank Act – require dealers to provide their counterparties with the option of having the independent amounts ("IA") that they post held with a third-party custodian. Market participants in other jurisdictions should consult with their local legal counsel and any other advisors/consultants.[53,54]

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[52] "A tri-party custodial arrangement consists of a tri-party control agreement among the pledgor, the secured party, and the custodian and sets forth the custodian's obligations to comply with the instructions of the parties with respect to the collateral in the account based on negotiated parameters. A tri-party control agreement may specify, for example, events upon which a pledgor may seek return of the IA and thereby limit or terminate the secured party's access to the IA; the timing of the return of IA to the pledgor when events arise entitling the pledgor to a return of IA; and the amount of IA that may be returned to a pledgor upon the occurrence of events entitling the pledgor to such a return. Because such tri-party control agreements frequently require time-consuming negotiations among the three parties and also require amendment of the NY CSA, the proposed Sample Tri-Party IA Provisions are intended to facilitate the negotiation process by providing a form of amendment to the NY CSA along with suggested language that may be incorporated into tri-party control agreements as the parties see fit." International Swaps and Derivatives Association. "Independent Amount Segregation: Summary of ISDA's Sample Tri-Party IA Provisions." Accessed 2012-03-06. <http://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&cts=1331048765140&ved=0CCMQFjAA&url=http%3A%2F%2Fwww2.isda.org%2Fattachment%2FMzgxOQ%3D%3D%2FISDA%2520Sample%2520Tri-PartyIA%2520Provisions%2520Memorandum.pdf&ei=tC9WT7TeLOLt0gGFuaGLCg&usg=AFQjCNERAKNQEsintFZ6Vz_vhHDdv0lFlA&sig2=uvHLK9NX28WwPJ3g60rEuQ>.

[53] International Swaps and Derivatives Association. "Independent Amount Segregation: Summary of ISDA's Sample Tri-Party IA Provisions." Accessed 2012-03-06. <http://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&cts=1331048765140&ved=0CCMQFjAA&url=http%3A%2F%2Fwww2.isda.org%2Fattachment%2FMzgxOQ%3D%3D%2FISDA%2520Sample%2520Tri-PartyIA%2520Provisions%2520Memorandum.pdf&ei=tC9WT7TeLOLt0gGFuaGLCg&usg=AFQjCNERAKNQEsintFZ6Vz_vhHDdv0lFlA&sig2=uvHLK9NX28WwPJ3g60rEuQ>.

[54] ISDA's 3 categories are: direct holding by an unaffiliated custodian; third party custody in which an unaffiliated bank, broker-dealer, or other party operates under an agreement with one or two counterparties and provides physical custody safekeeping services; and third party custody in which an unaffiliated bank or other party providing tri-party custodial services operates under a three-way contract between it and the two OTC derivatives counterparties and agrees to release collateral to the counterparty based on predefined conditions.

Section 724 of Dodd-Frank requires: (1) an FCM to segregate property of a customer and prohibits commingling of customer property with the FCM; (2) an FCM to commingle different customer property in a bank, trust company, or a clearing organization; (3) allows an FCM to withdraw and apply customer property to margin, settle, or adjust transactions or pay fees; (4) treats a cleared swap as a commodity contract for purposes of Title II§761 of the bankruptcy code; and (5) allows a customer in non-cleared swaps transactions to request segregation from the swap dealer or major swap participant and be carried by an independent third party custodian.

"Although the CFTC recently stated that an FCM may agree to maintain a third-party custodial account on behalf of a cleared swaps customer, such third party accounts are not permitted for exchange-traded futures accounts. Third-party custodial accounts would require an FCM to use its own capital to post initial margin with a DCO on behalf of a customer. Consequently, such accounts may adversely affect an FCM's liquidity. Importantly, the CFTC has emphasized that third party custodial accounts do not provide any greater protection to customers under the Bankruptcy Code in the event that an FCM fails and there is a shortfall in customer funds.[55]

[55] Commission Financial and Segregation Interpretation No. 10-1 prohibits an FCM from maintaining third-party custodial accounts on behalf of a futures customer, except in limited circumstances. Although the CFTC recently stated that a cleared swaps customer may agree with its FCM to maintain a third-party custodial account, the CFTC emphasized its view that, under the Bankruptcy Code, such accounts would not receive preferential treatment in the event of the FCM's insolvency. An FCM may agree to hold a portion of its customer segregated funds at a depository selected by the customer. However, a customer must recognize that, in accordance with the provisions of CFTC Rule 1.20, such funds are held in the name of the FCM for the benefit of its customers generally and not for the benefit of the requesting customer. Further, for operational efficiency, an FCM may limit the number of banks at which it maintains customer segregated accounts. In the event of the FCM's bankruptcy and a shortfall in customer funds available for distribution, the requesting customer would receive no greater protection than all other customers of the FCM.

The Futures Industry Association recommends that upon request of a customer, an FCM should identify for the customer the banks at which the FCM holds customer funds."[56]

6. Investment in affiliate's assets, securities, or deposits. Customers should consider whether the financial firm uses any affiliate as a broker, intermediary, internal clearance or settlement entity, collateral manager, custodian, counterparty, or a source of investments or deposits. Keep in mind that the term affiliate may vary based on practice or rules and customers should understand each entity involved in the chain.

Blurring the Segregation Line: How Certain Transactions Seem to Invite Trouble

Generally, we have seen that, although segregation is a "sacrosanct" principle, regulators and market participants have different views on the meaning of segregation depending on location, applicable law, product, entity involved, or stage of transaction. A further complication is that, in certain instances, the regulators breach or make exceptions to the concept of segregation.

1. Repurchase agreements. Reuse with rehypothecation of securities always raises the risk of customer property being commingled with others, transferred or held by another institution, and recorded as an asset or liability. The following examples illustrate how permitted and common property deployment techniques may result in difficulties in identifying and protecting customer property. In the context of futures transactions, the CFTC requires: (1) segregation of an FCM's funds and property from those of a customer

[56] Futures Industry Association. "Protection of Customer Funds – Frequently Asked Questions." Accessed 2012-04-22. <http://www.futuresindustry.org/downloads/PCF-FAQs.PDF>.

and separate accounting, daily computation, and records;[57] and (2) restricted and prudent investment of customer funds and property.[58]

But then the CFTC allows the use of customer funds or the combination of customer and proprietary funds that can make the future identification of funds more difficult especially when errors or defaults occur.

Furthermore, the CFTC allows a financial firm to use customer funds through repurchase agreements or reverse repurchase agreements with respect to a customer asset. The current CFTC rules allow an FCM/DCO to invest customer funds in: (1) US government securities; (2) municipal securities; (3) government-sponsored enterprises securities; (4) Federal Deposit Insurance Corporation ("FDIC") insured certificates of deposit; (5) commercial paper, notes, or bonds; (6) general obligations of a sovereign nation; and (7) interest in money market funds. This includes engaging in quickly reversible repurchase transactions with respect to these investments as long as the underlying securities are readily marketable, not specifically identifiable property, and where other conditions apply.[59] For years, the CFTC permitted "in house" transactions and "affiliate" exchanges, transfers, and repurchase agreements on the ground that the conflicts were manageable and the financial benefits would be used to the benefit of the FCM, and indirectly, the customer. These exceptions further blurred the lines and complicated the ability to separate customer property from that of an FCM.[60]

[57] 17 CFR 1.20, 1.32, 1.23, 1.24
[58] 17 CFR 1.22, 1.21, 1.25
[59] CFTC Regulation 17 CFR 1.25(d)
[60] The industry groups and clearinghouses supported retaining in-house transactions and affiliated transactions because they were "safe," conducted with a "regulated entity," allowed for faster and easier transactions that could protect customer property. Such transactions reduced execution time, required less recordkeeping because done within and FCM/BD, and required less manual processiong. The transactions also arguably allowed the FCM or FCM/BD to earn more money on a transaction (leading to healthier FCMs/BDs). The industry also said in-house

2. Excess fund requirements. A rule intended to protect FCM customer A's property from being misused to satisfy the obligations of FCM customer B also risks blurring the lines of segregation. An FCM may not use one customer's funds to meet the obligations of another customer. An FCM must use its own funds to make up any deficiency in a customer's account if the customer fails to have sufficient funds on deposit with the FCM to meet the customer's obligations. "FCMs are permitted, if not required as a practical matter, to maintain excess funds in the customer segregated accounts in order to comply with CFTC Rule 1.23. This latter rule prohibits an FCM from using one customer's funds to meet the obligations of another customer. An FCM must use its own funds to make up any deficiency in a customer's account if the customer fails to have sufficient funds on deposit with the FCM to meet the customer's obligations.

All FCM funds are held for the exclusive benefit of the FCM's customers while held in a customer segregated account. An FCM may withdraw its residual interest in the customer segregated account at any time, however, provided such withdrawal does not cause the FCM to violate its requirement to maintain adequate segregated funds.

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and affiliate transactions allowed for better capital management because transactions with non-affiliates could cause the balance sheet of the FCM to appear larger than in-house transactions. (Such transactions while they appear on subledgers are typically eliminated on the consolidated balance sheet.) Of course, the fact that there was less recordkeeping, higher profits for FCM or FCM/BD, or decreases in sizes of balance sheets should be a hint that there are risks as well. Moreover, the old rules permitted a firm to engage in repurchase transactions with affiliates. The CFTC therefore eliminated repurchase and reverse repurchase transactions with affiliated counterparties to protect customer funds and to establish consistency within the regulation which would no longer permit in-house transactions and currently prohibits investments in instruments issued by affiliates. (MF Global and New Edge had argued that former rule 1.2 5D assured that whether a repurchase transaction is with an affiliate or in nonaffiliated customer segregated account, the client funds and indeed the bankruptcy trustee of an insolvent FCM must return properly segregated customer funds to the customer regardless of whether the funds are held by an affiliate/in-house or third-party and such customer claim receives a priority established in the FCM liquidation provisions of Chapter 7: Section 766.) In the case of MF Global, the Financial Industry Regulatory Authority ("FINRA") noted that MF global financial statements indicated MF Global had entered into a purchase agreement with its affiliates collateralized with European sovereign debt at the affiliate. MF Global paid the affiliate fees for identifying the market opportunity and managing the collateral. In the case of MF Global, it may have legally taken customer funds and exchanged it for property or investments of affiliates or entered into repos.

CFTC Rule 1.12(h) requires an FCM to notify the CFTC immediately whenever it knows or should know that the total amount of funds on deposit in segregated accounts is less than the amount required to be held in segregation. The FCM is required to file a notice concurrently with its designated SRO. In order to assure that it is not required to file such a notice, FCMs generally maintain excess funds in the customer segregated account."[61]

3. Omnibus investments. The need for a financial firm to invest customer funds efficiently also can lead to blurring the segregation line. For example, in the context of the futures transaction, a customer is not able to direct the investment of the cash it deposits with an FCM. Investments of customer funds are made on an omnibus basis and FCMs cannot identify specific investments for the benefit of specific customers.

4. Collateral transformation. When a customer posts securities as margin that are not permitted to be deposited with a DCO to margin the customer's positions, an FCM may need the ability to hypothecate and rehypothecate securities in order to convert customer-owned securities to securities that are accepted by the DCO. This process is commonly referred to as collateral transformation. If a customer deposits securities that are permitted to be deposited with a DCO, the FCM nonetheless must be authorized to hypothecate and rehypothecate securities in order to transfer customer securities to a DCO to meet customer margin requirements and to enter into repurchase and reverse repurchase transactions with permitted third-parties.[62]

[61] Futures Industry Association. "Protection of Customer Funds – Frequently Asked Questions." Accessed 2012-04-22. <http://www.futuresindustry.org/downloads/PCF-FAQs.PDF>.
[62] Futures Industry Association. "Protection of Customer Funds – Frequently Asked Questions." Accessed 2012-04-22. <http://www.futuresindustry.org/downloads/PCF-FAQs.PDF>.

5. Movement of collateral: portability. Outside the conduct of customary transactions, other arrangements regulate the movement of collateral. In the clearing context, for regulatory and business efficiency reasons, several kinds of arrangements exist to protect customer property. These however also raise questions about the location and segregation of collateral.

   "Portability is the legal mechanism allowing, in case of default or insolvency of a clearing member, for the transfer by the clearinghouse (or the regulator) of the clearing member's customers' cleared positions and collateral to another solvent clearing member. By enhancing portability, legal frameworks can help to mitigate systemic risks arising from disruptions to the financial system in case of insolvency of a clearing member.

   Movement by clearinghouses of contracts and related collateral from a defaulting clearing member to a non-defaulting clearing member takes place through new contractual arrangements, sometimes supported by statutory provisions. Under such arrangements, the non-defaulting clearing member agrees to accept the defaulting clearing member's customer positions and collateral and the customers agree to accept the non-defaulting clearing member as a counterparty, commonly, without additional consent of the defaulting clearing member whose contract with the customer has been terminated as a result of its default. Positions and margins may be transferred as a unit or on a piecemeal basis.

The effectiveness of such a portability regime requires strong legal underpinnings. In particular the laws applying to derivatives or to insolvent clearing members should not limit the ability of customers to close out their position vis-à-vis the clearing member."[63]

6. Interlinking and cross-margining arrangements. There exist other arrangements to achieve the efficient use of collateral and risk reduction (through multilateral netting). These arrangements can enhance the protection of customer property but also have an impact on the use and location of customer property that affect the ability to identify and retrieve customer property. "Interlinking and cross-margining arrangements have been proposed to support the efficient use of capital in OTC derivatives clearing. However, there are a number of legal hurdles that need to be overcome to make such arrangements legally sound.

   Interlinking and cross-margining can be used to pursue different objectives. Traditionally, in securities clearing, interlinking has been viewed as a tool to promote competition among marketplaces. In particular, it is believed that competition is increased by enabling clearing members to use their clearinghouse's services without requiring them to adapt to (and bear the costs of) each clearinghouse. In contrast, with OTC derivatives clearing, the primary objective of interlinking and cross-margining arrangements would be to reduce counterparty risk through multilateral netting and to enhance the efficient use of collateral and capital.[64]

[63] IMF. "Global Financial Stability Report: Meeting New Challenges to Stability and Building a Safer System." Page 104-105. Accessed 2012-05-17. <http://www.imf.org/external/pubs/ft/gfsr/2010/01/pdf/text.pdf>.

[64] 1. Interlinking. Typically, interlinking arrangements take two basic forms. Actual arrangements may share elements of each form:

a. Member Link. In the "member link" model (sometimes called the "simple model"), clearinghouse1 is a clearing member of another clearinghouse2, with the same legal obligations and rights as any other clearing member ("access"). This requires the member-clearinghouse1, but not its clearing members, to adhere to the contractual

The connections formed among two clearinghouses and a clearing member in interlinking and cross margining arrangements lead to the transfer of customer property from one clearinghouse to another and therefore present more layers to the process of identifying customer property.

7. Safely invested does not mean safely segregated. The rules dealing with segregation of customer funds differ from the rules dealing with investment of customer funds. The difference can mislead counterparties and result in improper segregation. For example, if a broker-dealer or FCM tells you that your property/funds are invested safely according to regulatory standards, that does not tell you anything about where or how funds are separated from the financial firm, its customers, the clearinghouse, custodians,

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framework ("Rule Book") of the other clearinghouse2. Most importantly, the clearinghouse2 evaluates the creditworthiness and risk management systems of clearinghouse1 as a member and requires clearinghouse1 to post collateral and contribute to the financial resources of clearinghouse2. Thus, clearinghouse1 is exposed to the risk of clearinghouse2 default.

b. Interoperating Model. In the "interoperating" model, two or more clearinghouses enter into a comprehensive, integrated contractual arrangement to clear contracts on a mutual basis, without requiring their respective clearing members to become members of the other clearinghouses. The most typical example of interlinkage is when two clearing members that are counterparties in a trade each have a different clearing arrangement with two different clearinghouses.

The two clearinghouses then clear the trade. The arrangement is referred to as interoperability because the two clearinghouses cooperate and share information about each other's positions and risk management (including the demands for collateral posted by the clearing members) and may exchange collateral to cover the exposure of one clearinghouse to the other.

2. Cross-Margining. Cross-margining allows a clearing member to use the margin it posts at a clearinghouse as margin at another clearinghouse in order to reduce the amount of collateral for its various transactions. Cross-margining could take the form of "one-pot" or "two-pot" margin arrangements. For example, in a one-pot arrangement, the margin is calculated based on the clearing member's total exposure across both clearinghouses and held in a single account at a clearinghouse or at a custodian. If a clearing member defaults on its obligations to either clearinghouse, the clearing member's collateral would be liquidated and shared as agreed between the two clearinghouses. In a two-pot arrangement, the margin requirement for the clearing member, calculated based on the exposure to each clearinghouse, is held separately in each clearinghouse in different accounts.

In contrast to the bilateral nature of interlinking arrangements, the contractual relationships in cross-margining involve a tri-party arrangement: a clearing member agrees with two clearinghouses to use its collateral or positions at one clearinghouse as collateral or positions at the other clearinghouse." [IMF. "Global Financial Stability Report: Meeting New Challenges to Stability and Building a Safer System." Page 114. Accessed 2012-05-17. <http://www.imf.org/external/pubs/ft/gfsr/2010/01/pdf/text.pdf>.]

affiliates, counterparties, or others. Generally, as discussed, the rules dealing with segregation require customer funds be kept separate from proprietary funds.

In contrast to the rules on segregation, rules on investment of customer funds generally are meant to achieve two things: (1) avoid conflicts of interest or the possibility that a financial institution would take customer funds and invest them in products or securities of an affiliate; and (2) set minimum standards for the safe investment of customer funds.

8. <u>Differently regulated entities have different rules on segregation (and investment) of customer funds.</u> Banks, FCMs, broker-dealers, combined FCM/broker-dealers ("FCM/BD"), mutual funds, custodians and private funds, and financial conglomerates all have different rules about segregation and investment of the customer funds. In financial conglomerates, the trail of customer fund segregation and investment may become serpentine. Counterparties should focus on identifying all the entities holding their property and what rules govern such entities and whether their funds will be held by or reinvested with an affiliate perhaps regulated differently from the company with which they transacted.

9. <u>Location affects customer fund segregation and investment.</u> Rules and practice regarding segregation and investment may vary based on the jurisdiction of the client, the "transaction," the financial firm, or their intermediaries. Customers need to focus on location and need to understand that "location" is not always apparent. For example, the location of a transaction or product may be determined or affected by where the issuer is, what markets are affected, the location or type of reference asset, where the transaction partners are, where the custodian or clearing firm is located, etc.

10. Alternative Calculation Methods. As noted above, an FCM must perform calculations and set aside amounts it would owe if its customers' accounts were liquidated. "But the rules apply only to accounts in the United States. In 1987, the commodity commission approved a series of rules governing foreign futures and options transactions, one of which provided an alternative calculation of how much firms needed to put aside for accounts that traded on foreign exchanges.

The alternative calculation almost always resulted in a lower amount — sometimes much lower — that needed to be segregated in foreign accounts, because it covered only options and futures. Cash and securities held in customer accounts didn't count. So if a customer held only cash and securities, the firm had no segregation requirement at all."[65]

"MF Global's customers, who discovered that the firm had plundered $1.6 billion of their property, learned that the hard way. But they aren't the only potential victims. The loophole that allowed MF Global to convert more than $1 billion in customer property to its own reckless bet on European debt is still in effect — although the Commodity Futures Trading Commission, which regulates futures and commodities brokers, said it had since pressured other firms to stop using it."[66]

[65] New York Times. "A Loophole Big Enough to Lose a Billion." Accessed 2012-07-03. <http://www.nytimes.com/2012/06/23/business/mf-globals-billion-dollar-loophole-common-sense.html?pagewanted=all>

[66] New York Times. "A Loophole Big Enough to Lose a Billion." Accessed 2012-07-03. <http://www.nytimes.com/2012/06/23/business/mf-globals-billion-dollar-loophole-common-sense.html?pagewanted=all>

Recommendations

1. <u>Documentation: types of accounts, title transfer, or pledges.</u> There are a variety of forms and documentation to protect customer property which may vary based on product, counterparties, and the inclusion of DCO's, custodians, other financial firms, etc. Customers should review documentation to specify where and how client funds will be held – trust, custody, or otherwise – and whether the title is being transferred or whether there is a pledge of a security interest. Client documentation should indicate whether margin and collateral are required of clients and whether it must be posted.

2. <u>Due diligence.</u> A customer should: (1) consider how a financial firm monitors other firms where client property is held; (2) review the credit, legal, and operational risks posed by the custodian firm and clearinghouse and in what capacities the financial institution hold such monies; (3) review the attributes and practices of financial firms conducting such reviews; (4) understand the financial firm's responsibility if its due diligence is faulty or the DCO or the custodian of the financial firm fails; (5) review processes for a financial firm to select and monitor sub custody arrangements for holding client assets; and (6) consider whether the financial firm accepts liability for its agents or sub custodian's actions and inactions.