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FUTURES INDUSTRY ASSOCIATION 2020 LAW & COMPLIANCE VIRTUAL CONFERENCE PANEL: CLEARING 101

Sarah Riddell

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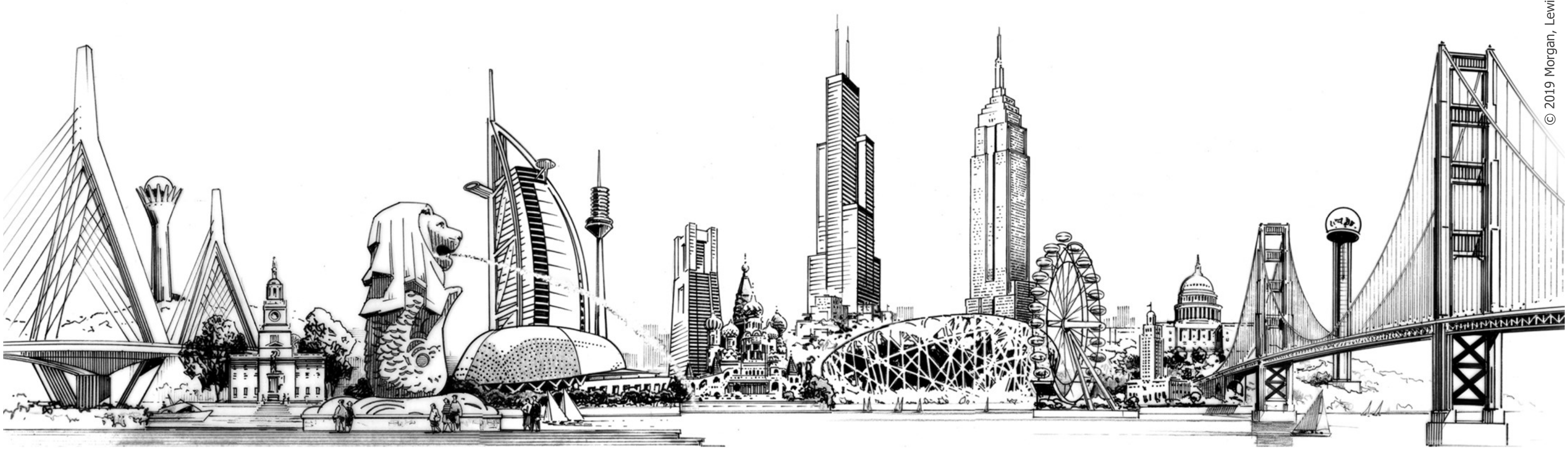
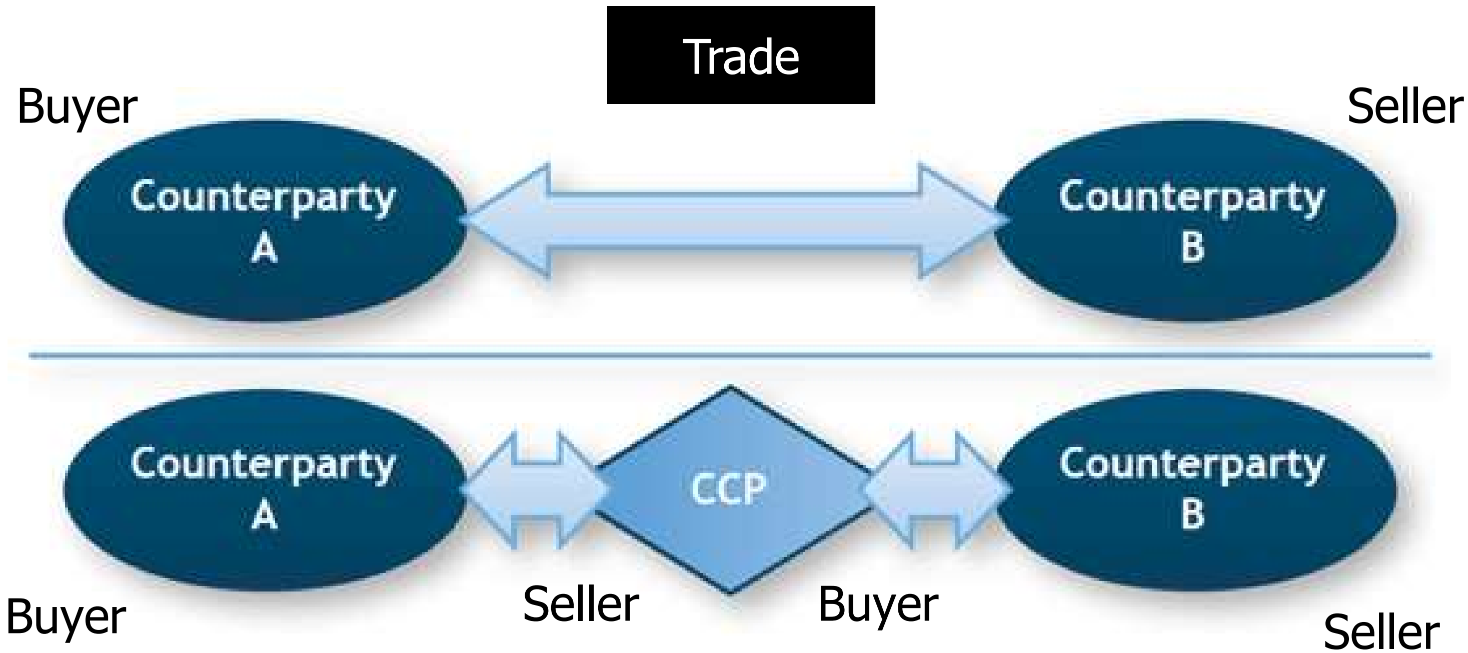


CLEARING OVERVIEW

NOVATION



Original contract is replaced with two contracts.

ROLES OF KEY PARTIES

Central Counterparty (CCP)

- A derivatives clearing organization (DCO), or CCP, guarantees the performance of cleared contracts (but does not guarantee delivery).
- After a transaction is executed and is accepted for clearing, the CCP becomes the buyer to the clearing member seller and the seller to the clearing member buyer. To clear futures contracts or swap contracts, a CCP must be registered with the CFTC as a derivatives clearing organization (DCO).
- DCOs are subject to the Core Principles in Section 5b of the Commodity Exchange Act and various regulatory requirements, primarily those under Part 39 of the CFTC's regulations.
- To become a member of a DCO, a firm must complete an application for clearing membership and be admitted as a member. A DCO sets margin requirements and guaranty fund contribution amounts for its clearing members and imposes other rules on its clearing members. Clearing members must demonstrate appropriate risk controls and operational capacity, and must satisfy capital requirements.

Clearing Members & Customers

- Clearing members can clear for their own account and/or for customers.
  - Separate clearing of "house" and "customer" trades, in separate house and customer accounts.
  - An FCM acts as agent for customers, but the CCP looks to the FCM for financial performance as guarantor or as if principal. Customers do not have a direct relationship with the CCP.
- Clearing members with customers must be registered with the CFTC as futures commission merchants and, as such, are subject to minimum regulatory capital, risk management, and customer fund segregation requirements, among others. CCP risk management and capital requirements apply to proprietary clearing, too.
- Clearing members must comply with CCP margin requirements, and must make margin calls to their customers.

Settlement Banks / Depositories

- An FCM must segregate customer funds from its own funds. An FCM may deposit customer funds only with banks, trust companies, DCOs, or other FCMs.
- Generally, a depository must provide the FCM with a written acknowledgment letter in the format provided in CFTC Regulation 1.20. The depository must agree, in the acknowledgment letter, to:
  - Provide the director of DSIO with direct, read-only electronic access to transaction and account balance information for customer accounts;
  - Permit accounts containing customer funds to be examined at any reasonable time by the director of DSIO or the director of DCR, or the FCM's DSRO;
  - Reply promptly and directly to any request from the director of DSIO or the director of DCR, or the FCM's DSRO for confirmation of account balances or provision of any other information regarding or related to an account.

In each case, the written acknowledgment must contain the FCM's authorization to the depository to take these actions without further notice to or consent from the FCM.

CFTC

- The Division of Clearing and Risk oversees DCOs; it performs the following tasks (among others):
  - Proposes regulations to which DCOs are subject.
  - Reviews DCO applications and makes recommendations to the Commission to grant a DCO order or to deny an application.
  - Performs periodic DCO examinations.
  - Performs periodic settlement liquidity analyses to assess the impact of a hypothetically extreme but plausible market scenario on the ability of a DCO to meet its settlement obligations on time.
  - Works with DCOs when a clearing member defaults.

BENEFITS OF CLEARING

Risk Management

- CCPs impose admission and ongoing membership requirements on clearing members, including financial reporting, risk management and monitoring.
- Clearing reduces (but does not eliminate) counterparty risk, or the risk of nonperformance of the contract if a counterparty becomes unable to perform its contractual obligations. Counterparty risk is mutualized by a CCP.
- Clearing enables multilateral netting (summing up and offsetting the amounts a CCP owes each of its clearing members with the amounts each member owes the CCP during a settlement cycle).
- Daily mark-to-market variation margin helps to prevent risk from building up in the system. The CFTC requires DCOs to collect initial margin on a gross basis for each customer account.

Margin

An FCM must have sufficient funds on deposit at a CCP to assure performance of a futures or cleared swap contract. CCPs require an FCM to deposit specific types of collateral to satisfy margin requirements.

- **Initial margin / performance bond** is collected by FCMs from customers and by CCPs from clearing members.
  - Initial margin helps cover potential losses if the customer or clearing member defaults.
  - Clearing members typically set higher initial margin requirements for their customers than a CCP requires from FCMs for their customer trades.
- **Variation margin** is the result after contracts are marked-to-market each day as a further assurance of performance.
  - The mark-to-market computation will result in a demand for more margin if the market has moved adversely to a party's position and a daily recognition of losses in cash.
  - A CCP does not hold variation margin, but collects and pays variation margin on a pass-through basis. An FCM credits gains and debits losses to customer accounts.
- In the event that margin funds are not sufficient to cover a loss, the customer will still be liable for the deficit. In addition, the customer's FCM is responsible to the CCP for any deficit.
- Margin calls are made at certain times during the day and must be met by deadlines imposed by the CCP or FCM.

Customer Funds Segregation

- Pursuant to Section 4d of the Commodity Exchange Act, an FCM must

  "treat and deal with all money, securities, and property received by such person to margin, guarantee, or secure the trades or contracts of any customer of such person, or accruing to such customer as the result of such trades or contracts, as belonging to such customer."
- The CFTC's futures customer funds segregation regime differs from the cleared swaps customer collateral regime, referred to as LSOC (LSOC reduces fellow customer risk, which exists under the futures regime).
- An FCM must separately account for and must not commingle customer funds with its own funds. However, customer omnibus accounts are permitted.
- An FCM may only invest customer funds in certain types of instruments, as specified in CFTC Regulation 1.25.
- Segregation is required for futures customer funds, cleared swaps customer funds, and secured amount / 30.7 customer funds.
- An FCM must maintain residual interest as a buffer in the customer segregated account to help ensure that customer obligations are fulfilled. The residual interest amount is considered customer funds while held in a customer segregated account.

Default Management Plans

- DCOs must establish default management plans pursuant to CFTC Regulation 39.16. A default management plan must describe the roles and responsibilities of a DCO's board of directors, risk management committee, other relevant committees, and senior management in addressing a default, including coordination with regulators. The plan must address procedural differences with respect to highly liquid products and less liquid products.
- DCOs must have rules to specify the default waterfall of resources that are used to satisfy clearing member defaults.
- DCOs also must have rules to define "default" and the actions the DCO will take upon a default.

Example of Standard Default Waterfall

Defaulting Clearing Member's Initial Margin

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Defaulting Clearing Member's Default Fund/Guaranty Fund Contribution

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CCP Capital
(the CCP's "skin in the game")

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Default Fund/Guaranty Fund Contribution from Non-Defaulting Clearing Members

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CCP Assessment Powers
(the unfunded component of the waterfall, called from clearing members if all prior resources are insufficient to cover the losses of the defaulter)

Portfolio Margining

- Hold securities and futures, swaps and futures, or foreign futures and US futures positions in the same account and impose margin requirements based on the risk of the portfolio, which allows market participants to save capital and benefit from operational efficiencies (such as fewer margin calls) by clearing positions in a single account when the positions provide risk offsets and when such commingling of positions is permitted by the CFTC and/or the SEC.
- ICE Clear Credit
  - Available for house and customer positions in credit default swaps ("CDS") (broad-based index CDS, narrow-based index CDS and single-name CDS), with customer positions and customer funds held in a single swap customer account subject to the customer segregation requirements of Section 4d(f) of the Commodity Exchange Act and the CFTC's rules.
- CME
  - CME offers portfolio margining of over-the-counter interest rate swap positions and Eurodollar and Treasury Futures for customer accounts (among other offerings).

SWAPS

Mandatory Clearing

- Section 2(h) of the Commodity Exchange Act requires certain swaps to be cleared by a DCO or an exempt DCO if the CFTC has issued a clearing determination for the swap, unless certain exceptions apply.
- Market participants may voluntarily clear swaps even if the swaps are not subject to a clearing determination and, in fact, this is done for some swaps.

`INTEREST RATE SWAPS REQUIRED TO BE CLEARED

Specification	Fixed-to-Floating Swap Class			
1. Currency	U.S. Dollar (USD)	Euro (EUR)	Sterling (GBP)	Yen (JPY)
2. Floating Rate Indexes	LIBOR	EURIBOR	LIBOR	LIBOR
3. Stated Termination Date Range	28 days to 50 years	28 days to 50 years	28 days to 50 years	28 days to 30 years
4. Optionality	No	No	No	No
5. Dual Currencies	No	No	No	No
6. Conditional Notional Amounts	No	No	No	No

Specification	Basis Swap Class			
1. Currency	U.S. Dollar (USD)	Euro (EUR)	Sterling (GBP)	Yen (JPY)
2. Floating Rate Indexes	LIBOR	EURIBOR	LIBOR	LIBOR
3. Stated Termination Date Range	28 days to 50 years	28 days to 50 years	28 days to 50 years	28 days to 30 years
4. Optionality	No	No	No	No
5. Dual Currencies	No	No	No	No
6. Conditional Notional Amounts	No	No	No	No

LSOC

"Legally Segregated, Operationally Commingled"

- FCMs and DCOs must segregate cleared swaps positions and related collateral of each individual customer and relevant collateral in its books and records. However, FCMs and DCOs are permitted to commingle the relevant collateral in one account, provided that such account is separate from other accounts (such as proprietary accounts or accounts belonging to non-cleared swaps customers).
- DCOs are prohibited from using the value of collateral from one customer of an FCM to cover another customer's losses.
- LSOC with Excess permits a DCO to accept a customer's excess margin provided that it has rules to accept and hold excess funds.
- Part 22 of the CFTC's rules set forth the LSOC regime.
- LSOC was selected as the segregation model for cleared swaps to decrease fellow customer risk, increase the likelihood of portability, decrease systemic risk, and positively impact portfolio margining.

Uncleared Swap Margin Rules

- Margin requirements applicable to swap dealers and major swap participants under Part 23 of the CFTC's rules apply to uncleared swaps unless an exception applies (e.g., for end users) or if there is an applicable exemption from clearing. (Note: The Prudential Regulators also have uncleared swap margin rules, generally consistent with the CFTC rules.)
- Phased-in approach for initial margin requirements.
- Variation margin requirements became effective for swaps between a swap dealer or major swap participant and their counterparties on March 1, 2017.

CLEARING MEMBER DEFAULT AND BANKRUPTCY RULES

Bankruptcy Concepts

- Relevant concepts
  - Mutualization of losses (all clearing members contribute to the guaranty fund, which is part of the default waterfall)
  - Fellow customer risk (non-defaulting customers' funds of the defaulting FCM may be used to cover a loss in the customer account)
  - Double default (a customer defaults on its obligation to its FCM and the loss is so great that the FCM defaults on its obligation to the CCP)
  - Default waterfall
    - When a clearing member defaults, a CCP generally draws on the initial margin and guaranty fund contribution of the defaulting clearing member.
    - A CCP may draw on the remainder of the guaranty fund, use its own assets, or use its assessment powers to cover the obligations of the defaulting clearing member.

Part 190 of the CFTC’s Rules

- Subchapter IV of chapter 7 of the Bankruptcy Code applies to “commodity broker” bankruptcies.
- Part 190 of the CFTC’s rules help administer an FCM’s bankruptcy. Part 190 separates customers and customer property by account class.
- One of the key concepts of Part 190 is the customer account classes. In the event of a shortfall in the FCM’s customer funds, the FCM’s customers are preferred over the FCM and any non-customer creditors of the FCM.
- The goal in an FCM bankruptcy is to port customer positions and related margin funds in a specific number of days (by the end of the 7th calendar day after the bankruptcy order is issued) and to liquidate any positions that cannot be transferred.

Clearing Member Bankruptcies

- Although FCM bankruptcies are extremely rare, the following firms became insolvent:
  - MF Global
  - Peregrine Financial Group Inc.
  - Griffin Trading Company
  - Sentinel Management Group, Inc.

October 31, 2011

CFTC-SEC Statement on MF Global

Washington, DC – The Commodity Futures Trading Commission and Securities and Exchange Commission today made the following joint statement:

"For several days, the SEC, CFTC and other regulators had been closely monitoring developments affecting MF Global, Inc., a jointly registered futures commission merchant and broker-dealer, in anticipation of a transaction that would include the transfer of customer accounts to another firm. Early this morning, MF Global informed the regulators that the transaction had not been agreed to and reported possible deficiencies in customer futures segregated accounts held at the firm. The SEC and CFTC have determined that a SIPC-led bankruptcy proceeding would be the safest and most prudent course of action to protect customer accounts and assets. SIPC announced today that it is initiating the liquidation of MF Global under the Securities Investor Protection Act (SIPA)."

Biography

Sarah V. Riddell

Chicago

T +1.312.324.1154

F +1.312.324.1001

sarah.riddell@morganlewis.com

Sarah V. Riddell is an associate in the Investment Management practice of Morgan, Lewis & Bockius LLP. Leveraging her experience as a lawyer at the U.S. Commodity Futures Trading Commission (CFTC), Sarah advises domestic and foreign exchanges, derivatives clearing organizations, swap execution facilities, and other financial institutions on a broad range of regulatory matters, including CFTC registration and developing related policies and procedures. Sarah represents private investment fund sponsors and advisers on regulatory matters and assists clients with regulatory examinations. Sarah works with regulators to obtain no-action and exemptive relief on behalf of clients. While at the CFTC, Sarah worked on Dodd-Frank related rulemakings and participated in examinations of derivatives clearing organizations, including those designated as systemically important.

In addition, Sarah helps clients understand and comply with the NFA's Information Systems Security Program interpretive notice and the New York Department of Financial Services Cybersecurity Regulation, as well as related cybersecurity questions. Sarah has assisted clients who have experienced cybersecurity attacks, assisted in the cybersecurity investigation including an assessment of the forensic analysis about the incident, and drafting and submitting notifications to customers and regulatory agencies.

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