July 25, 2011
VIA ELECTRONIC SUBMISSION

David Stawick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
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secretary@cftc.gov

Re: Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions (RIN 3038-AC99) (Federal Register Vol. 76, No. 111, Page 33818)

Dear Mr. Stawick:

I appreciate the opportunity to comment on the Commodity Futures Trading Commission's (the "CFTC" or "Commission") Notice of Proposed Rulemaking ("Notice") that was published in the Federal Register on June 9, 2011. In the Notice, the Commission specifically seeks comment on and proposed questions regarding whether to implement a model that permits DCOs to offer the Physical Segregation Model for cleared swaps customer collateral for some set of customers of their FCM members, with the remaining cleared swaps customer collateral staying in an omnibus account under the Futures Model. Below appear my answers to the questions posed by the Commission.

QUESTION 1: How would such a model work in the ordinary course of business (i.e., pre-FCM member default)? For example, how would an FCM and a DCO structure their respective cash flows to accommodate such model?

> In the ordinary course of business, the DCO, the customer, the FCM and the custodial bank will create an account. Depending on the Commission's view, the account would be in the name of the DCO with the customer as the beneficial owner, or in the name of the customer with the DCO having complete control over the disposition of the assets in the account. The FCM will be granted a secondary lien on the account with respect to any amounts owed to the FCM by the customer in respect of the swaps clearing business with the DCO. The FCM will be required to guarantee performance of the customer. The custodian bank would acknowledge the segregated status of the account in accordance with Commission standards.
>
> All collateral required by the DCO will be deposited in this account. All pays from the clearing house to the customer will be made to the account. Depending on the Commission's view, efficiency considerations and resolution of potential bankruptcy questions, the amounts necessary to cover variation payments to the clearing house will

be paid to the clearing house directly by the customer or by the FCM on the customer's behalf.

QUESTION 2: To the extent that an FCM or DCO may structure their cash flows in different ways, what are the issues, costs, or risks of each way?

I do not foresee any specific risk associated with any of the alternative cash flows discussed above after the point at which the collateral or variation payments to the DCO reach the customer's account. If the collateral or variation margin payment is held by the FCM at the moment of bankruptcy, I expect that it will be deemed customer property and subject to pro rata distribution and possible loss due to "fellow customer risk." This risk can be mitigated if the customer directly funds its account and directly withdraws from the account.

There are obvious costs to maintaining an individual account and paying for two or more transfers per day. Our best estimate of the bank's charges for establishing and maintaining such an account, based on discussions with buy-side customers is approximately $25,000 per anum. Of course, there may be additional fees from the customer's FCM and the clearing house.

QUESTION 3: What changes to proposed Part 22 and Part 190 should the Commission make to accommodate this model?

The CEA as amended by DFA and interpreted by the CFTC in various NPRs provides clear authority for clearing houses to utilize individually segregated accounts for certain classes of customers. See, RIN 3038–AC99, Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions, 76 Federal Register 33818, 33819 (June 9, 2011). For the avoidance of doubt, Part 22 should be amended to permit a customer to opt into an individually segregated account at the clearing house level and, for the avoidance of residual doubt, Part 190 should be amended to find that "cash, securities, other property, or commodity contracts" held in such account at the clearing house level are not "customer property" in accordance with section 761(10)(B) of the Bankruptcy Code.

QUESTION 4: Who (e.g., the cleared swaps customer, FCM member, and DCO) would have what rights in cleared swaps customer collateral at every stage of clearing (including with respect to initial margin and variation payments and collections)?

As noted in response to questions 1 and 2, the DCO will have an absolute right to use the collateral and variation margin payments in the customer's account in accordance with its rules to cover that customer's obligations to the clearing house, but for no other purpose. The FCM will have no rights to the assets in the customer's account except in respect of its secondary lien in the event that the customer is indebted to the FCM in respect of a swap transaction cleared by means of that account.

QUESTION 5: In the event of an FCM bankruptcy, would such cleared swaps customer collateral constitute ‘‘customer property’’ subject to ratable distribution pursuant to section 766(h) of the Bankruptcy Code?

The customer's collateral, including any variation margin paid into the customer's account by or on behalf of the customer and variation margin paid into the account by the DCO as end of day or intraday settlement will not be deemed "customer property" and will not be subject to ratable distribution pursuant to section 766(h) of the Bankruptcy Code. As noted above, if the customer chooses to use its FCM as an intermediary for the transmittal of collateral or variation margin, the customer's property in the control of the clearing member at the time of the clearing member's bankruptcy will be deemed customer property subject to ratable distribution.

The Commodity Futures Trading Commission, as well as some market participants, have argued that an individual customer cannot protect itself against fellow customer risk by setting up an individually segregated customer account. It has been argued that section 766 of the Bankruptcy Code requires a ratable distribution of customer property irrespective of whether such property is held in segregated or omnibus customer accounts. This view is well accepted in respect of the distribution of "customer property." See 6 COLLIER ON BANKRUPTCY 766.05 (Alan N. Resnick & Henry J. Sommer eds., 15th rev. ed.) ("Section 766(h) expresses the distribution concept of the commodity broker liquidation subchapter that all public customers shall receive a pro rata distribution of customer property, whether or not some may have held a greater amount of specifically identifiable property than others."); cf. *McKenny v. McGraw (In re Bell & Beckwith)*, 937 F.2d 1104, 1108 & n.3 (6th Cir. 1991) (examining a similar provision in the Securities Investor Protection Act providing for ratable distribution on account of net equity and observing that "every customer's claim is to be included in the pro rata calculation of customer property").

"Customer property" is a defined term in the Bankruptcy Code and a term that the Commission has limited authority to interpret to the extent of determining: "that certain cash, securities, other property, or commodity contracts are to be included in or excluded from customer property." [1] If the "cash, securities, other property, or commodity

[1] SEC. 20. (7 U.S.C. 24) (a) Notwithstanding title 11 of the United States Code, the Commission may provide, with respect to a commodity broker that is a debtor under chapter 7 of title 11 of the United States Code, by rule or regulation—
(1) that certain cash, securities, other property, or commodity contracts are to be included in or excluded from customer property or member property;
(2) that certain cash, securities, other property, or commodity contracts are to be specifically identifiable to a particular customer in a specific capacity;
(3) the method by which the business of such commodity broker is to be conducted or liquidated after the date of the filing of the petition under such chapter, including the payment and allocation of margin with respect to commodity contracts

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contracts" in an account held for the benefit of a customer at the clearing house level are excluded from the definition of customer property by the Bankruptcy Code and that exclusion is upheld by a bankruptcy court, the contents of a customer segregated account at the clearing house level may not be treated as customer property and will not be subject to fellow customer risk by reason of any applicable ratable distribution scheme.

Section 761(10)(B) of the Bankruptcy Code excludes from the definition of "customer property" any property for which "a customer does not have a claim against the debtor based on such property." If a customer with a segregated account is precluded by rule and/or agreement from asserting any claim against its clearing member with respect to such property, so that its sole claim is against the clearing house, property held by a clearing house in an individually segregated account should not constitute "customer property" subject to ratable distribution by the trustee under section 766(h). Forgoing any rights that a customer might have against the clearing member minimizes the possibility that a court would find the customer to have a "claim" against the clearing member on account of the segregated customer account, which claim could bring the account within the definition of customer property. See 11 U.S.C. § 761(10)(A)(i), (B).

As a result, a customer's assets held in an individually segregated account at the clearing house level should not be subject to the ratable distribution process. Any residual doubt as to the categorization of the individually segregated account can be alleviated by the Commission's exercise of its authority under section 20 of the CEA to confirm that the assets in the individually segregated account are not "customer property" subject to ratable distribution.

Accordingly, segregated customer accounts can be quite effective at mitigating fellow-customer risk, both by removing a bankruptcy trustee's ability to distribute property in an individually segregated account and by enabling a clearing house to intervene quickly to transfer the positions and collateral of non-defaulting customers held in individually segregated accounts.

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not specifically identifiable to a particular customer pending their orderly liquidation;
(4) any persons to which customer property and commodity contracts may be transferred under section 766 of title 11 of the United States Code; and
(5) how the net equity of a customer is to be determined.
(b) As used in this section, the terms ‘‘commodity broker’’, ‘‘commodity contract’’, ‘‘customer’’, ‘‘customer property’’, ‘‘member property’’, ‘‘net equity’’, and ‘‘security’’ have the meanings assigned such terms for the purposes of subchapter IV of chapter 7 of title 11 of the United States Code.

QUESTION 6: To what extent would the answer to this question depend on the manner in which the FCM and the DCO structured their respective cash flows in the ordinary course of business?

> See the response to Question 5.

QUESTION 7: To the extent cleared swaps customer collateral is removed from customer property'': What vulnerabilities might that raise for the protection of such collateral in an FCM or a DCO bankruptcy? For example, is there a risk that, in some circumstances, such property might be deemed to be part of a bankrupt FCM's or DCO's bankruptcy estate subject to the claims of creditors other than the relevant swaps customers?

> I do not foresee either of those risks with respect to a cleared swaps customer's collateral held in a properly documented account that is operated in compliance with that documentation. The CEA, as interpreted by the CFTC, demands individual segregation of swaps customer collateral; bankruptcy courts have respected segregated accounts and refused to treat the accounts as part of the bankrupt commodity broker's estate.

QUESTION 8: What changes would need to be made to self-regulatory organization audit programs to ensure protection of cleared swaps customer collateral pre-bankruptcy?

> Assuming that this question relates to the individually physically segregated accounts at the clearing house level, no changes to the audit program ordinarily performed in respect of customer segregated accounts will be necessary. Additional resources may be needed, depending on the number of customers that choose this option. Obviously, significant resources may be needed if the Complete Legal Segregation Model ("CLSM") route is selected and the DCO is required to validate the new daily information flows required or audit FCM practices.

QUESTION 9: Should such a model be an option elected by cleared swaps customers, or mandatory for defined ''high-risk'' customers?

> It is not clear what is meant by "high-risk" customers. Customers per se can't be categorized on a risk scale. The risk a customer poses to its FCM and to the DCO depends on the risks of a customer's portfolio, the customer's ability to immediately cover any variation margin it owes to the FCM or DCO, and the FCM's ability to implement credit controls to limit the customer's ability to alter the risk profile of its portfolio without adequate collateral. It is uncertain that this sort of "risk" can be known or anticipated at the point at which the individually segregated account structure for the customer would be created.

> I believe that the individual segregation model should be optional for a customer subject to its FCM's ability to make the option available and subject to conditions established by the DCO during a pilot program stage to insure that it is not overwhelmed by thousands of small accounts.

I do not believe that an option elected by customers presents any moral hazard. If there were such a thing as a "high-risk" customer, that customer would achieve no benefit by electing to remain in the pool, which is no benefit at all given the cost of maintaining an individual account and the benefit presumed by the Commission of avoiding fellow customer risk.

QUESTION 10: By whom would the definition of ‘‘high-risk’’ be set?

This question is not relevant to my proposal.

QUESTION 11: What criteria should be included in the definition of ‘‘high risk’’?

This question is not relevant to my proposal.

QUESTION 12: Would the definition of ‘‘high risk’’ vary by asset class?

This question is not relevant to my proposal.

QUESTION 13: To the extent the model is optional by a cleared swaps customer, to what extent might there be a tendency for cleared swaps customers posing greater risk to remain in the omnibus pool?

I don't believe that there is a basis to presume that the availability of individual segregation creates an adverse selection risk of the sort posed by the question. By "greater risk," you must mean more likely to default on its obligations to its FCM and the clearing house and create a potential for harm to fellow customers. I think that we can agree that a cleared swap customer does not present any significant risk to its fellow customers unless it both holds a very large directional position and is unable to cover a loss in excess of its collateral. I am unaware of a principle or process that is likely to cause a customer meeting these conditions to tend to remain in the omnibus pool. First, the decision to opt into individual segregation will need to be made in advance and it will be reviewed by both the clearing member and by the DCO in my model. It is unlikely that the customer will perceive itself as posing a greater risk at the time the decision is made or that the customer will want to remain in the pooled account where it gains no benefit from its own default. Second, if the customer is large enough to present this sort of risk, it is likely to be in the class of buy-side customers who have expressed a demand for a genuine individual segregation model and who can most easily afford the costs. It is not clear that one can classify cleared swaps customer into categories of lesser and "greater risks." Finally, both the customer's FCM and the DCO have strong incentives to prevent customers from assuming positions that they are unable to manage, regardless of the account structure. A well managed DCO's risk management policies and procedures will apply equally to all customer accounts, whether the account is part of the customer omnibus account or individually segregated. The risk of each customer's portfolio is balanced by standard and concentration collateral requirements and regular reduction of debt by daily marking to market. In addition, DCOs deploy additional risk management measures, in the form of position limits, capital requirements, etc. to deal with additional forms of exposure.

Finally, the benefits promised by the proponents of CLSM are illusory. If it works (which presumes it is within the Commission's authority to adopt and will be respected in a bankruptcy court—both of which propositions are questionable)[2] as the NPR suggests, it will only protect against fellow-customer risk in a highly unlikely scenario. Consider the usual case in which a fellow customer brings down the clearing member and creates fellow customer risk. It is usually the case that on a day when there has been a large enough market move to cause a default in the involved clearing member's customer segregated account at the clearing house level, the clearing member will have customers who are both long and short the contracts that moved in excess of collateral coverage. At 7:30 in the morning, when settlement for the previous day's price changes takes place, the clearing member will not have defaulted. The clearing house will net the pays and collects among the customers. Assume the customer likely to fail owed $2 billion and the other customers were owed $1.9 billion. At 7:30 the clearing house's customer segregated account held $2 billion in collateral equally divided between the winners and losers. The clearing house would collect $100 million from the customer segregated account. At 7:31 the clearing member would begin the process of collecting $2 billion from the failing customer to make its other customers whole. At 7:45 the clearing member realizes it won't be paid and declares bankruptcy. Unless the Commission intends to unwind lawfully completed transactions, which it did not disclose, the customers who were told that they were protected against fellow customer risk will find that the customer segregated account is short approximately $1 billion (depending on the beginning collateral of the winners and losers) and they will be cast as general creditors of the clearing member in respect of that claim. The CLSM will offer them nothing but illusory protections.

The NPRM chooses to call it a segregation model, but there is no segregation. It is a pool of customer assets and treated like a pool during its entire history until its last day after bankruptcy. There is no precedent that would justify assuming that the bankruptcy court will accept this fiction. In reality, CLSM is an unfunded insurance scheme. The customers of an FCM are being told that they are guaranteed against fellow customer risk, but they will not be required to pay any premium. The Commission has plainly shifted the risk from a customer who has chosen the wrong clearing member, to the clearing house and those clearing members who did not fail.

[2] The CFTC's proposals for changing the customer segregation regime for swaps do not provide a reasoned legal discussion explaining that the new regime will be upheld by a bankruptcy court. There is no legal basis for the CFTC's conclusion that the definition of customer property, in the Bankruptcy Code, can be overridden by a regulation dividing that property into separate pools depending on the nature of the derivative product to which the property is related. The CFTC's plan to depart from the futures model, in which customer collateral and variation margin are pooled at the clearing house level, to a model in which the collateral and variation margin of customers are "legally segregated" despite the fact that the collateral and variation margin are physically pooled has not been tested nor is there precedent that provides comfort as to the outcome in the event of a test in a bankruptcy court.

QUESTION 14: What policy concerns, if any, might be raised by the inclusion of a larger concentration of cleared swaps customers posing greater risk in the omnibus pool?

> There is no basis to assume that this state of affairs will exist. The fairer assumption is that every customer that could cause fellow customer risk will opt into individual segregation, since each of these customers can easily bear the additional direct costs and administrative burdens and since this set of customers is more worried about being injured by the failure of other customers than about their own failure. Therefore, this model is more likely to protect the customers in joint segregation from fellow customer risk than the untested CLSM.

QUESTION 15: Please provide a detailed quantitative analysis of the costs and benefits of this model relative to other models that are being considered in this NPRM, and relative to the existing uncleared swaps market. Please specify how each cost and benefit would be ultimately allocated to, or borne by, cleared swaps customers, FCMs and DCOs.

> The additional costs for individual segregation can be assessed against the customers that are able to take advantage of this alternative. If the individual segregation model, as proposed, is coupled with the traditional futures model and the other customers are in pooled accounts, there will be no other costs borne by them or the clearing members. This is obviously a more rational allocation of costs.

QUESTION 16: Specifically, how would this type of model affect operational costs and Risk Costs?

> The operational costs will depend on the number of accounts that opt into separate segregated accounts. A fair assumption is that the added costs to those who chose individual segregation compared to the "implicit cost" of bearing fellow customer risk will limit the use of these accounts to a few very large buy-side firms that are unwilling or unable to become self-clearing members. Under such circumstances the additional operational costs of managing those accounts should be relatively small.
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> The costs should be about the same as the obvious "risk cost" in the proposed CLSM. The proposed model will accomplish what CLSM promises, but cannot deliver. The clearing house and its solvent members will absorb any losses caused by a failed customer and protect the other customers. Under both the CLSM and the genuine segregation model, a prudent clearing house and its risk committee must imagine that it has become an insurer against fellow customer risk, that at any time the customer with the largest risk profile will default and will not contribute any additional collateral to cover its loss. The principal difference between the two models is that CLSM presents significant legal risks including in the bankruptcy court. Moreover, a customer who chooses individual segregation is far more likely to have its positions and collateral transferred immediately upon the default of its clearing member as compared to

customers in the CLSM, who must wait for positions and collateral to be sorted out at a time when their clearing member is unlikely to be functioning effectively.

I thank the Commission for the opportunity to comment on this matter. I would be happy to discuss any of these issues with Commission staff. If you have any comments or questions, please feel free to contact me at **Jerrold.Salzman@skadden.com** or (312) 407-0718.

Sincerely,

Jerrold E. Salzman

CC: Robert B. Wasserman, Associate Director, Division of Clearing and Intermediary Oversight