

MEMORANDUM

To: Robert Wasserman

From: Jerrold Salzman

RE: Legal Segregation of Certain Customer Accounts
to Minimize Fellow-Customer Risk

The following comments should only be attributed to me and not my firm or my clients. While I continue to believe that the current segregation model has proved effective and efficient, the purpose of this Memorandum is to suggest that the Commission look beyond its two proposals to redo the system of customer segregation (LSOC and back-of-the-waterfall) and seek public comment on additional options to minimize fellow-customer risk and achieve other significant benefits. I think it is worthwhile to assess the value of creating a limited number of individual customer segregated accounts at the clearing house level. Soliciting public comment at this time is the best way to gauge whether many prospective market participants would find this alternative attractive or worthy of serious consideration as a means to addressing fellow-customer risk.

Individually segregated customer accounts for exchange-traded futures and DCO cleared swaps can play an important role in avoiding "fellow-customer risk," *i.e.*, protecting non-defaulting customers from the consequences of a simultaneous failure of their clearing member and a default by another customer of that clearing member. In the event that customer assets are in pooled segregation at the clearing house level, the clearing house's use of customer collateral and variation could deplete the assets held for the benefit of non-defaulting customers below the calculated net asset value for those customers. Although no customer of CME has suffered a

loss because of such an occurrence, we understand that there has been concern expressed by a number of customers in the context of new efforts to clear swap transactions.

OPTIONAL INDIVIDUAL SEGREGATION: A model that permits customers seeking protection against fellow-customer risk to opt out of the segregation pool into an individual segregated account at the clearing level should effectively protect such customers against fellow-customer risk. A model that also permits a manager of substantial individual accounts to pool its clients into a single segregated account should effectively protect those clients against fellow-customer risk due to customers outside of that manager's segregated account. The permissive opt out model should protect the opt out customer from fellow-customer risk and will permit the clearing house to impose all of the costs, including the risk related costs, on the opt out customer.

MANDATORY INDIVIDUAL SEGREGATION: A model that requires those customers of a clearing member, whose open positions and/or trading activity present the most significant risk to the continued viability of the clearing member, to maintain individually segregated customer accounts at the clearing house should effectively protect the other customers of the clearing member from any significant fellow-customer risk. It is assumed that the customers who are not forced to opt out do not present any significant risk to fellow-customers.

The risk of failure of an opt out account is borne directly by the clearing house, which can effectively reimpose the direct costs and risks of maintaining that separate account on the relevant customers. Such accounts can be collateralized at levels sufficient to avoid consequences of a default on other clearing members and the clearing house. While this raises the cost of clearing, certain proponents of this alternative have asserted that they are willing to pay the cost. In the public comment process, members of the public should comment on how

the level of "significant risk" should be determined, what that level might be for different asset classes, and whether they are willing to pay the additional costs to gain the benefits of individual segregation.

ANALYSIS: If a clearing member's insolvency is caused by a default of one or more customers with individually segregated customer accounts at the clearing level, no other customer will suffer a "fellow-customer loss." The clearing house is prohibited from using the variation margin due to, or the collateral of, other customers to cover the obligation of the defaulting customers.¹ In such circumstances, the variation margin due to non-defaulting customers and their collateral would be available to them in full. This will make transfer of non-defaulting customers to one or more clearing members a simple process.

In contrast, under the existing framework, the default of a large customer and its clearing member is likely to result in the clearing house exercising its right to net variation payments due to customers of that clearing member and to make use of all collateral in the customer origin account to cover any shortfall to the clearing house. Consequently, non-defaulting customers have come to perceive some risk of incurring losses in the event that a fellow-customer default coincides with the insolvency of the clearing member. Pursuant to section 766(h) of the Bankruptcy Code, non-defaulting customers would be left to share, on a ratable basis, whatever customer property remains after the clearing house has made use of variation and collateral in its customer origin account of defaulting clearing member.

In contrast, a non-defaulting customer with an individual segregated account at the clearing level should be able immediately to transfer its positions and all collateral and

¹ Clearing houses can mitigate the risk of large customer defaults by means of heightened collateralization or additional guarantee fund contributions from clearing members whose customers maintain individual accounts. The additional costs of individual accounts can be imposed directly on participants in the program.

variation margin in that account to another clearing member in the event of its clearing member's insolvency. Moreover, there should be no barrier to that customer combining its swap and futures positions, collateral, and variation margin in that individually segregated account and, thereby, achieving the most advantageous capital efficiencies. These benefits should be available to a non-defaulting customer regardless of whether the customer default that coincides with a clearing member's default occurs in another individually segregated account or in the joint customer origin segregated futures or swaps account.

If a clearing member becomes insolvent in consequence of or coincidentally with a default by a customer of that clearing member, property of a customer held by the clearing house in an individually segregated account should be beyond the reach of the clearing member's bankruptcy trustee and not be subject to dilution by reason of the ratable-distribution rule. 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."² 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

² The Commodity Futures Trading Commission, as well as some market participants, have argued that segregated customer accounts will not protect customers from fellow-customer risk because, among other things, 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 may be correct for purposes of distributing 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"). But segregated accounts that do not qualify as customer property would not be subject to this ratable distribution scheme.

the trustee under section 766(h).³ As a result, a customer's assets held in an individual segregated account at the clearing house level should not be subject to the ratable distribution process.⁴

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 non-defaulting customers. The individual opt out model may raise adverse selection issues if the riskiest customers remain in pooled segregation and it may be appropriate to seek comment on that issue.

All of these models assume that customers continue to be guaranteed by their clearing members and that all cash flows, previous to the insolvency of the clearing member, are identical to the current system used to clear futures. As a result, all customer variation and collateral under control of the clearing member at the moment of its insolvency should be deemed customer property subject to the ratable distribution rule. However, the prohibition against using customer A's property to cover customer B's obligations, should protect against fellow-customer risk. I suggest that interested parties be asked to describe any issues, costs or risks of using the clearing member as an intermediary to transmit collateral and variation margin to and from the clearing house.

³ 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).

⁴ 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. *Griffin* is not an impediment.