



DERIVATIVES END-USERS: CROSS-BORDER ISSUES AND DEVELOPMENTS

MF Global and MF Global UK: What Every End-User of Futures and OTC Derivatives Should Be Thinking

In our previous update for derivatives end-users, we had asked if your contracts were ready for clearing of OTC derivatives.¹ Since then, the collapse of MF Global has raised a number of concerns primarily in the context of futures but equally likely to apply to cleared OTC derivatives. Clearinghouse standards and the mechanisms for transferring (or ‘porting’) positions and collateral related to cleared swaps are not fully developed and are yet to be tested by a futures commission merchant (“FCM”) or clearing member insolvency. In the U.S., the shortfall in customer assets has exposed flaws in the regulatory framework and gaps in the regime for prudential supervision. In particular, end-users should be concerned about potential loopholes in the customer protection rules, as well as the possibility that their FCM may simply not follow the rules and place customer assets at risk. In the UK, futures customers of MF Global UK Limited (“MF Global UK”) are experiencing for the first time the ‘Special Administration Regime’, a newly-established administration procedure designed to promote a more rapid return of client assets. The failure of MF Global UK has highlighted certain problems with porting of positions and collateral to new clearing members as well as the risks associated with principal-to-principal clearing models. This update will briefly summarize these issues and propose some ideas that could help to mitigate the potential risks.

How Safe Are Your Funds?

MF Global Inc. was dually registered as an FCM with the U.S. Commodity Futures Trading Commission (“CFTC”) and as a securities broker-dealer (“BD”) with the U.S. Securities and Exchange Commission (“SEC”).² Separate and conflicting procedures exist under the CFTC’s Part 190 bankruptcy rules, the Bankruptcy Code and the Securities Investor Protection Act (“SIPA”) for liquidating an insolvent dually-registered FCM/BD. Only securities accounts are

¹ “Are Your Contracts Ready for OTC Clearing and Collateral Segregation?” (*available at* <http://www.sidley.com/sidleyupdates/Detail.aspx?news=4957>).

² Like MF Global Inc., many FCMs are also registered broker-dealers, so in many cases the same entity will be a clearing member for both a clearinghouse handling CFTC-regulated swaps and a clearinghouse handling SEC-regulated security-based swaps. For purposes of this update, when referring to an FCM in the context of swaps trading we also mean to refer to a broker-dealer that is a clearing member with respect to a clearinghouse that handles security-based swaps regulated by the SEC.

insured under SIPA. If an FCM becomes insolvent, a trustee is appointed to liquidate the assets of the FCM and return customer property. Futures customer property is not part of the FCM's estate and is therefore not subject to the claims of an FCM's creditors. The trustee is required to distribute to all futures customers (a) specifically identifiable property belonging to a particular customer and (b) net equity claims of customers based on their futures contracts held by the FCM. If there are deficiencies in the customer accounts, customers will share pro rata in the shortfall and have claims against the FCM for the shortfall amounts. Post-bankruptcy, the trustee or the clearing organization may transfer futures customer accounts to a solvent FCM. However, if there is a shortfall in the accounts or if the clearing organization applies a haircut to the transfer, the new FCM could require customers to post additional margin to maintain their positions. Pursuant to section 724 of the Dodd-Frank Act, several variations of these segregation requirements have been proposed by the CFTC for the collateral of OTC cleared swaps end-users of an FCM.

With respect to MF Global's futures customers, assets held in the customers' futures accounts were supposed to be protected by CFTC regulations that require the segregation of futures customers' cash and collateral posted in connection with their futures trading. Pursuant to section 4d(a)(2) of the Commodity Exchange Act ("CEA") and CFTC Rules 1.20 and 30.7, MF Global was required to maintain a segregated account for its customers trading on U.S. futures markets and a secured amount account for its customers trading on non-U.S. futures markets, each account being granted priorities in the event of MF Global's bankruptcy. These accounts were required to be kept separate from MF Global's proprietary accounts. MF Global was required to hold customers' assets at separately identified segregated accounts at an FCM, custodial bank or a designated clearing organization. Segregated assets must be calculated daily and an FCM is required to report any undersegregation to its designated self-regulatory organization. Most FCMs on a daily basis add their own cushion to the segregated accounts to ensure against undersegregation. What went wrong at MF Global to cause it to be undersegregated? Well, the regulators, Congress, the SIPA trustee and the former director of the FBI are trying to make that determination. But, several risks inherent in the CFTC's regulations may have enabled abuse.

Regulatory Risk 1. Prior to the CFTC revisions to its rules approved on December 5, 2011, CFTC Rule 1.25 allowed an FCM to invest its customers' segregated assets in "permitted investments," which included obligations of the U.S., general obligations of any state, government sponsored enterprise securities, commercial notes and bonds, money market mutual funds and, surprisingly, general obligations of a sovereign nation (think Greece and Italy) and certain repurchase agreements. On December 5, 2011, the CFTC approved an amendment to CFTC Rule 1.25, prohibiting investments in foreign sovereign debt, in-house transactions and repurchase agreements with affiliates.³

Regulatory Risk 2. CFTC Rule 1.23 recognizes that an FCM may not commingle its customers' segregated funds with the FCM's proprietary assets, but it allows an FCM to have a residual financial interest in its customers' funds.

Regulatory Risk 3. CFTC Rule 1.29 permits an FCM to receive and retain as its own any increment or interest resulting from the FCM's investment of its customers' segregated funds. This regulation may incentivize risk-taking.

Regulatory Risk 4. Contrary to popular belief, there is no CFTC requirement that an FCM top up its customer segregated account that suffers a shortfall. CFTC Rule 1.23 provides that the CFTC's segregation rules do not prevent an FCM from adding to such customer segregated accounts from its own funds as it may deem necessary to ensure the customers' accounts from becoming undersegregated, but this is permissive, not mandatory.

These risks, contained in CFTC regulations, may have created a potentially unsafe customer protection regime. The best way to mitigate against FCM risk is to understand these regulatory risks and to carefully negotiate key provisions in

³ Under the revised CFTC Rule 1.25 approved by the CFTC on December 5, 2011, the scope of permitted investments is narrowed to prohibit investments in foreign sovereign debt. The rulemaking also prohibits in-house transactions and repurchase agreements with affiliates. Repurchase agreements with third-parties are still allowed, subject to a 25% counterparty concentration limit. These changes had been proposed prior to the MF Global collapse but had been delayed, in part, by lobbying on the part of MF Global. An FAQ regarding this amendment is available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/125_qa_final.pdf

your futures and OTC clearing agreements with your FCMs, to select only the most creditworthy, highly-capitalized and compliance oriented FCMs, and if your FCM is part of a financial holding company, to require a parental guaranty.

Issues to Ponder: Mitigating FCM Risk

The concerns raised by the MF Global bankruptcy should cause all end-users to carefully consider their FCM relationships, whether these relate to clearing of OTC derivatives or to regular futures contracts. End-users may want to meet with their FCM to discuss the FCM's procedures in respect of segregated funds and review their existing FCM customer agreement in light of the risks in relying largely on the regulatory and supervisory regimes for protection. End-users that do not currently have a customer agreement with an FCM should consider the same issues in their search for appropriate FCM relationships. The following is a brief list of issues to think about when looking at the FCM customer agreement with MF Global in mind:

- *Segregation of customer assets:* it may be prudent to discuss with the FCM the procedures it follows in segregating your assets.
- *Reinvestment of customer assets:* discuss with your FCM the scope of financial instruments that customer segregated assets will be invested in.
- *Margin top-up:* if the posted collateral declines in value due to the FCM's reinvestment, the FCM should be obligated to top-up.
- *Margin levels:* ideally, these should be limited to clearinghouse and regulatory minimums in order to limit the amount of assets at risk. To the extent an FCM insists on over-collateralization, the end-user might propose a tri-party custody arrangement for such excess, analogous to the arrangements contemplated for initial margin under uncleared OTC derivatives transactions.
- *Monitoring status of assets:* the end-user may want to be able to monitor where assets are held and how they are invested. This could also involve the FCM providing a risk profile report upon reasonable request. Although it is unlikely that an FCM would agree to audit rights, larger end-users may be able to negotiate some audit rights triggered upon the occurrence of a rating downgrade or other event(s).
- *Porting commitments:* end-users might consider negotiating commitments with additional FCM's that will ensure a "safe haven" in the event their cleared OTC swaps need to be moved quickly from an FCM in distress.
- *Margin for ported positions:* because of the risk of haircuts on customer collateral at the time of porting from a distressed FCM, end-users should think about the FCM agreeing reasonable margin levels relating to ported positions.
- *Multiple FCMs:* consider whether you should maintain multiple clearing member (*i.e.*, FCM) relationships to mitigate credit risk and provide options for porting (as well as to ensure full access to the relevant traded products).
- *Consider the jurisdiction and regulators of your FCM:* very different rules apply.

UK/European Issues

MF Global UK (along with its affiliated entity MF Global UK Services Limited) is the first investment firm to be administered under the new 'Special Administration Regime', a new administration procedure for investment banks which recently came into force in the UK. The procedure has three key objectives, namely to ensure the return of client assets as soon as practicable, to ensure timely engagement with market infrastructure bodies to resolve failed trades, and either to rescue the firm as a going concern or to wind it up in the best interests of its creditors.

The insolvency of MF Global UK has highlighted a number of areas of concern for end-users, including:

- *Reducing unsecured risk:* at the time of writing, the UK administrators have indicated an intention to return money to clients by the end of the first quarter of next year. However, end-users may be able to reduce or eliminate unsecured risk against a clearing member by requiring that the ‘unsecured’ portion of collateral which a customer posts to its clearing member (*i.e.* the amount by which the clearer is over-collateralized when compared with the amount of collateral it posts to the clearinghouse) is held on a segregated basis with a third party bank or custodian.
- *Bilateral close-out:* bilateral events of default and close-out netting provisions are more relevant under a UK clearing agreement because of the principal-to-principal nature of European markets. A clearinghouse may port positions and supporting collateral held at clearinghouse level, but an end-user may be left with ongoing exposure under its matching transactions with the insolvent clearing member unless it can apply close-out and netting (including against any ‘surplus’ collateral held by the clearing member for its positions).
- *Back-up clearing member:* the demise of MF Global UK has shown the importance of having more than one clearing relationship, including the appointment of a ‘back-up’ clearer. The transfer of positions and collateral to an alternative clearing member is likely to be a faster and smoother process where an end-user can show an existing relationship with the transferee clearing member.
- *Client money:* although there may (at the time of writing) be fewer concerns in relation to missing cash in MF Global’s UK operations than in the U.S., there is still widespread misunderstanding among end-users as to the effect of the UK Financial Services Authority’s client money rules and how the rules are interpreted and applied by clearing members. End-users should assess issues such as how much cash is required to be segregated with third party banks, when that segregation obligation arises and which third party banks they take credit risk on. End-users should also assess the risks of participating in pooling arrangements including omnibus accounts.
- *Gross and net margining:* unlike U.S. clearing models, which generally require margin to be posted gross (*i.e.* the clearinghouse holds margin gross for all clearing member positions), in the UK clearing member positions are generally margined on a net basis at the level of the clearinghouse. End-users should be aware that, where net margining applies, insufficient margin will be available to support porting of positions to an alternative clearing member. End-users should assess clearinghouse capabilities for gross and net margining, the risks involved in participation in net margining clearing models and the consequences of positions being held in omnibus accounts on a net basis at the level of the clearinghouse (*i.e.* these are treated as the positions and margin of the clearing member, not the customers). End-users should assess whether it is possible to create individual customer accounts at clearinghouse level (a subject already under debate in relation to clearing OTC derivatives).

Next Steps

In order to be able to properly assess risks, end-users will need to (a) discuss with their FCMs the procedures used to protect customer segregated funds accounts and (b) conduct a thorough legal and contractual risk analysis of the relevant clearing framework and their futures customer agreement(s) in conjunction with their legal counsel. As we have noted previously, given that a typical clearing member customer agreement is written by the clearing member itself, it tends to favor the interests of the clearing member. In anticipation of widespread clearing of OTC derivatives, end-users will also need to consider whether the customer documentation adopted for a futures platform adequately takes into account certain features that distinguish cleared OTC swaps from futures contracts. The bankruptcy of MF Global raises additional concerns about clearing member risk that are not addressed in the customer agreement (and for which applicable clearinghouse rules do not provide sufficient comfort). Careful review and negotiation of the clearing member customer agreement is therefore advisable, and existing clearing member customer agreements may warrant re-negotiation.

Previous updates in our series for end-users of OTC derivatives are available at www.sidley.com:

- [Update 1: What Is a “Swap”?](#)
- [Update 2: Inter-Agency Request for Comments on “Key Definitions” of Title VII](#)
- [Update 3: CPO/CTA Registration Requirements under Dodd-Frank](#)
- [Update 4: What Is a “Major Swap Participant”?](#)
- [Update 5: Segregation of Client Collateral for Uncleared Derivatives under Title VII of Dodd-Frank](#)
- [Update 6: Are Your Contracts Ready for OTC Clearing and Collateral Segregation?](#)

If you have any questions regarding this update, please contact any of the following Sidley lawyers:

Antony Bryceson	+44.20.7360.3711	abryceson@sidley.com
Miki Navazio	+1.212.839.5310	mnavazio@sidley.com
Michele Ilene Ruiz	+1.312.853.7187	mruiz@sidley.com
Michael S. Sackheim	+1.212.839.5503	msackheim@sidley.com
Elizabeth M. Schubert	+1.312.853.2935	eschubert@sidley.com

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