SULLIVAN & CROMWELL LLP

MEMORANDUM TO THE FUTURES INDUSTRY ASSOCIATION
AND
THE INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC.

Regarding Futures and Options Transactions, Cleared ~~Swap Contracts~~Swaps and Foreign Futures Transactions Executed and Carried by Futures Commission Merchants for Their Customers

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I. INTRODUCTION

This memorandum addresses certain matters under New York and U.S. federal law relating to the rights of a futures commission merchant (an "*FCM*") in connection with (1) futures contracts or options on futures contracts (collectively, "*U.S. futures contracts*") cleared by the FCM for a customer through a derivatives clearing organization registered as such (a "*DCO*") with the Commodity Futures Trading Commission (the "*CFTC*") under the Commodity Exchange Act (the "*CEA*"), (2) swap contracts cleared by the FCM for a customer through a DCO ("*cleared swaps*" and collectively with futures contracts, "*cleared customer transactions*"), and (3) futures contracts or options on futures contracts made on or subject to the rules of a foreign board of trade and cleared by the FCM for a customer through a person that is a member of the foreign board of trade[1] ("*foreign futures contracts*" and collectively with cleared customer transactions, "*customer transactions*") pursuant to an account agreement (a "*customer agreement*") that establishes a clearing relationship between the customer and the FCM and a clearing account for the customer on the books").

For purposes of the FCM (a "*customer account*") in which the customer transactions are carried. this memorandum, we refer to U.S. futures, cleared swaps and foreign futures, collectively, as a customer's "*transactions*."

In addition, this memorandum addresses certain matters under New York and U.S. federal law relating to (a) the rights of an FCM that clears security-basedsingle-name credit default swaps ("*SNCDS*") that are margined oncarried in an account maintained by a portfolio basisbroker-dealer who is also an FCM in accordance with cleared customer transactions,Section 4d(f) of the CEA ("*Portfolio-Margined SNCDS*"), and (b) the rights of an affiliate of an FCM (an "*uncleared swaps affiliate*") in respect of its cross-affiliate netting rights in respect of bilateral (*i.e.*, uncleared) swap transactions ("*uncleared swaps*") with a customer.

In particular, this memorandum addresses the following questions:

1. When an FCM clears aU.S. futures or cleared customer transactionswaps for a customer through a DCO pursuant to a customer agreement, what is the nature of the relationship (i) between the FCM and itsthe customer, (ii) between the FCM and the DCO, and (iii) between the customer and the DCO?

2. When an FCM clears a foreign futures contract made on or subject to the rules of a foreign board of trade and cleared by the FCM for a customer through a person that is a member of the foreign board of trade (a "*foreign*

[1] The foreign board of trade may or may not be registered with the CFTC as a DCO. However, if the foreign board of trade has adopted the FCM model with the approval of the CFTC, then transactions cleared through the related clearing organization will be addressed by our discussion of cleared customer transactions, as noted in footnote 2.*infra* note 35.

futures broker~~"),~~"), what is the nature of the relationship (i) between the FCM and ~~its~~the customer, (ii) between the FCM and the foreign futures broker, and (iii) between the customer and foreign futures broker?

3. When an FCM clears ~~single-name credit default swaps ("~~Portfolio-Margined SNCDS~~") and margins~~ in the customer's ~~SNCDS transactions on a portfolio basis with~~ cleared swaps customer ~~transactions,~~account,[2] what is the nature of the relationship between the FCM and its customer?

4. When a customer grants a security interest to an FCM in any of ~~its customer accounts, customer~~the accounts established by the FCM for the customer under the customer agreement (individually or collectively, the "*account*" or "*customer account*"), transactions, and associated customer funds, how is that security interest perfected?

5. On what basis does an FCM liquidate[3] the customer transactions of a defaulting customer? Does the FCM do so as (i) the customer's agent, (ii) a secured party enforcing its security interest in the ~~customer~~customer's transactions, or (iii) a principal exercising its contractual right to cause the ~~termination~~close-out of the customer transactions?

6. On what basis does the FCM ~~calculate~~determine a single ~~net~~final cash balance due to or from a ~~single~~ defaulting customer in respect of the customer's account, reflecting (i) the losses incurred and gains realized in liquidating the ~~customer~~ transactions ~~of~~carried for the customer, (ii) the unpaid amounts due to or from the customer under the customer agreement, (iii) any other ~~amounts~~costs incurred by the FCM in connection with its provision of services or its exercise of remedies and charged to the customer's ~~customer~~ account, and (iv) the value of any margin held by the FCM, in accordance with the customer agreement?

7. Would the FCM ~~be entitled~~have the right to ~~carry out~~effect the liquidation of ~~the customer~~ a defaulting customer's account, including the transactions ~~of~~ and customer funds carried in the account, and determine the ~~single net~~final cash balance due to or from ~~a single defaulting~~ the customer, as described above, ~~in~~as a result of the ~~context~~commencement of a

[2] Please refer to Section IV below for a discussion of the cleared swaps customer account.

[3] The term "liquidate" means (in relevant part) "To settle (an obligation) by payment or other adjustment; to extinguish (a debt). 2. To ascertain the precise amount of (debt, damages, etc.) by litigation or agreement. . . . To convert (a nonliquid asset) into cash." LIQUIDATE, Black's Law Dictionary (11th ed. 2019). In the context of the liquidation of a customer's account, as discussed in Sections IV and XI below, the terms "liquidation" and "close-out" are used interchangeably to mean the process by which the customer funds, and the customer's beneficial interest in transactions carried in its account, are converted into a single net obligation owed by the customer to the FCM or by the FCM to the customer. Please see Sections IV and XI below for more detail.

proceeding in relation to the customer under (i) the bankruptcy of the customer under Chapter 7, 9 or 11 of Title 11 of the U.S. Code (the "*Bankruptcy Code*~~"),~~"), (ii) the liquidation of the customer under the Securities Investor Protection Act of 1978, as amended ("*SIPA*~~"),~~"), (iii) the conservatorship or receivership of the customer under the Federal Deposit Insurance Act, as amended (the "*FDIA*~~"),~~"), (iv) the receivership of the customer under Title II ("*OLA*~~"~~)") of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, as amended (the "*Dodd-Frank Act*~~"),~~"), (v) the conservatorship or receivership of the customer under the Housing and Economic Recovery Act of 2008, as amended ("*HERA*~~"),~~"), or (vi) the rehabilitation or liquidation of the customer under the insurance insolvency regime of a jurisdiction addressed by Section~~-~~ XII.G?

8. On what basis would the FCM be entitled to ~~set off or apply any~~ determine a final cash balance for the customer's account after liquidation of all transactions and customer funds ~~held~~carried in each account or sub-account included in the customer's account by aggregating any credit balance remaining with respect to the accounts or sub-accounts of one account class~~ after the liquidation of the customer transactions within that account class against~~[4] with any ~~obligations of the customer that remain outstanding after~~ debit balance remaining with respect to the ~~liquidation~~accounts or sub-accounts of ~~the customer transactions in~~ any other account class?

9. Would the FCM be ~~entitled to exercise~~precluded from exercising the rights described in paragraph 8 above, ~~in~~as a result of the ~~context~~commencement of (i) ~~the~~a bankruptcy ~~of the customer~~proceeding under Chapter 7, 9 or 11 of the Bankruptcy Code, (ii) the liquidation of the customer under SIPA, (iii) the conservatorship or receivership of the customer under the FDIA, (iv) the receivership of the customer under OLA, (v) the conservatorship or receivership of the customer under HERA, or (vi) the rehabilitation or liquidation of the customer under the insurance insolvency regime of a jurisdiction addressed by Section~~-~~ XII.G?

10. On what basis would an uncleared swaps affiliate be entitled to exercise a security interest granted to it by a customer in the ~~amount (if any) payable by~~ customer's account, including the ~~FCM~~transactions and customer funds carried in the account, and any credit balance remaining with respect to the ~~customer~~account after the liquidation of the customer's ~~cleared~~transactions and customer ~~transactions, including any remaining margin held by the FCM for that customer~~funds, to secure the customer's

[4] Please see Section IV below for a discussion of account classes and the operation of the related accounts or sub-accounts.

obligations under the uncleared swaps between the customer and the uncleared swaps affiliate as a result of the customer's default?

11. Would the FCM be ~~entitled to exercise~~precluded from exercising the rights described in paragraph 10 above, ~~in~~ as a result of the ~~context~~commencement of (i) ~~the~~a bankruptcy ~~of the customer~~proceeding under Chapter 7, 9 or 11 of the Bankruptcy Code, (ii) the liquidation of the customer under SIPA, (iii) the conservatorship or receivership of the customer under the FDIA, (iv) the receivership of the customer under OLA, (v) the conservatorship or receivership of the customer under HERA, or (vi) the rehabilitation or liquidation of the customer under the insurance insolvency regime of a jurisdiction addressed by Section- XII.G?

The analysis in this memorandum is limited to the federal laws of the United States and the laws of the State of New York, and we ~~are expressing~~express no views as to the effect of the laws of any other jurisdiction except to the extent expressly set forth in Section- XII.G.

With respect to the laws of the other jurisdictions ~~set forth~~discussed in Section- XII.G, we do not practice law in any of those jurisdictions and we have not consulted attorneys practicing in any of those jurisdictions in preparing this memorandum. Our analysis of the laws of the other jurisdictions set forth in Section- XII.G is based entirely on a review of those jurisdictions' enactments of the NAIC Model Acts (as defined in Section- XII.G) related to "qualified financial contracts" (as defined under those Acts). We have assumed that each such jurisdiction's adoption of the NAIC Model Acts' provisions would be interpreted in accordance with the plain meaning of those provisions. We have further assumed that, to the extent the adoption of the model provisions related to "qualified financial contracts" by such a jurisdiction (other than New York) varies from the language set forth in the NAIC Model Acts, such modifications would be interpreted by the courts in such jurisdiction as a New York court would interpret such modifications if adopted in the New York statute. We have not reviewed any regulatory interpretations, legislative history ~~or~~, case law ~~in~~or other materials in or relating to any jurisdiction other than New York. We would, of course, be pleased to make further inquiries with counsel practicing in any of such jurisdictions at your request.

II. SCOPE OF CUSTOMERS, CUSTOMER AGREEMENTS, CUSTOMER TRANSACTIONS AND FCMS ADDRESSED BY THIS MEMORANDUM

This memorandum addresses the following types of customers, customer agreements, customer transactions and FCMs:

1. A customer is addressed by this memorandum if it is:

(a) An individual, corporation, limited liability company, partnership or business trust (as defined in Section 101(9)(A)(v) of the Bankruptcy Code) that, in each case, resides or has a domicile, a place of business, or property in the United States, or a municipality (including an FCM, and including a mutual fund that is organized as one of the foregoing), and that is subject to a proceeding under the Bankruptcy Code;

(b) A broker-dealer that is a member of the Securities Investor Protection Corporation ("*SIPC*"), including a broker-dealer that is also an FCM and that is subject to a liquidation proceeding under SIPA;

(c) A state- or federally chartered banking or savings institution whose deposits are insured by the Federal Deposit Insurance Corporation (the "*FDIC*") under the FDIA (an "*insured depository institution*");

(d) A bank holding company as defined in the Bank Holding Company Act of 1956, as amended (the "*BHCA*"); a nonbank financial company supervised by the Board of Governors of the Federal Reserve System (the "*Federal Reserve Board*") pursuant to Section 113 of the Dodd-Frank Act, a company predominantly engaged in activities that the Federal Reserve Board has determined are financial in nature or incidental thereto for purposes of the BHCA, or a U.S. subsidiary of any of the above engaged in activities that the Federal Reserve Board has determined are financial in nature or incidental thereto for purposes of the BHCA (other than an insurance company or insured depository institution), in each case with respect to which the Secretary of the Treasury has made a systemic risk determination as described in Section 203(b) of the Dodd-Frank Act; and a proceeding has been commenced under OLA;

(e) The Federal National Mortgage Association or any of its affiliates, the Federal Home Loan Mortgage Corporation or any of its affiliates, or a Federal Home Loan Bank; or

(f) AnA "*covered insurance company*," which means an insurance company formed under the laws of one of the Covered Insurance Jurisdictions (as defined in Section XII.G), excluding any financial guaranty insurance companies formed under the laws of New York or Wisconsin, and except that (1) for insurance companies formed under the laws of New Jersey, only with respect to insurance companies writing life insurance, health insurance or annuities; and (2) for insurance companies formed under the laws

of Tennessee, only with respect to life insurance companies ~~(any such insurance company, a "*covered insurance company*").~~.

Customers addressed by this memorandum do not include any other type of person or entity, such as a customer that is a state- or federally licensed branch or agency of a foreign bank; an insurance company other than ~~an insurance company formed under the laws of a Covered Insurance Jurisdiction (as defined in Section XII.G), except that, with respect to insurance companies formed under the laws of a Covered Insurance Jurisdiction, this memorandum (x) does not include any customer that is a financial guaranty insurance company formed under the laws of New York or Wisconsin and (y) only includes insurance companies formed under the laws of Tennessee that are life insurance companies and insurance companies formed under the laws of New Jersey that write life insurance, health insurance or annuities~~a covered insurance company; a pension fund, including a pension fund subject to the insolvency regime administered by the Pension Benefit Guaranty Corporation; an ordinary private trust governed by an insolvency regime other than the Bankruptcy Code; a credit union; a political subdivision, public agency, governmental entity or instrumentality of any U.S. state, except for a municipality subject to proceedings under the Bankruptcy Code; or a government-sponsored enterprise other than those listed in paragraph 1(e) above.

2. A customer agreement is addressed by this memorandum if it has the characteristics described in Section- IV of this memorandum.

3. An FCM is addressed by this memorandum if it is a futures commission merchant registered as such with the CFTC under the CEA, and either is a clearing member of one or more DCOs registered as such with the CFTC under the CEA (each such FCM, a "*clearing member*~~"), clears transactions on an omnibus basis for other FCMs through a clearing member or a chain of one or more FCMs, one of which clears through a clearing member (each such FCM, an "*intermediate FCM*"), or clears customer transactions on an omnibus basis for customers through an intermediate FCM or clearing member (each such FCM, a "*non-clearing member FCM*").~~").

III. EXECUTIVE SUMMARY

This section summarizes the responses provided in this memorandum to the eleven questions listed in Section- I above. More detailed analyses and explanations are provided throughout the memorandum and cross-references are included in this section as applicable. Subject to those more detailed analyses, and the assumptions and qualifications contained in this memorandum:

1. In the context of an FCM clearing ~~a~~U.S. futures or cleared ~~customer transaction~~swaps for a customer through a DCO pursuant to a customer

agreement, (i) the nature of the relationship between the FCM and its customer is properly characterized as a principal to agent relationship ~~(though with significant statutory trust and contractual~~, there are also aspects of the relationship that ~~result in~~reflect rights and obligations of the FCM ~~acting in a principal capacity~~and customer as debtor and creditor or otherwise as principals with respect to ~~the DCO in certain situations, as discussed below);~~one another; (ii) the nature of the relationship between the FCM and the DCO is properly characterized as a principal-to-principal relationship; and (iii) there is no contractual relationship between the customer and the DCO.[5] Please see Section I of this memorandum for a more detailed discussion of the relationships between a customer, FCM and DCO in the context of ~~cleared customer~~ transactions.

2. In the context of an FCM clearing ~~a~~ foreign futures ~~contract~~ made on or subject to the rules of a foreign board of trade and cleared by the FCM for a customer through a foreign futures broker, (i) the relationship between the FCM and its customer is properly characterized as a principal to agent relationship; (ii) the relationship between the FCM and the foreign futures broker is a contractual relationship, likely subject to foreign law and regulation; and (iii) there is no contractual relationship between the customer and the foreign futures broker. Please see Section VII of this memorandum for a more detailed discussion of these relationships.

3. In the context of ~~an FCM clearing~~Portfolio-Margined SNCDS ~~that are margined on a portfolio basis with cleared customer transactions~~, the relationship between the FCM and its customer is properly characterized ~~as a principal to agent relationship with~~in the same ~~statutory trust elements~~manner as the relationship between the FCM and its customer with respect to cleared swaps, as discussed above in ~~Section VI~~paragraph 1. Please see Section ~~VIII~~ VIII of this memorandum for a more detailed analysis of this relationship.

4. When a customer grants a security interest to an FCM in any of its ~~customer~~ accounts, ~~customer~~ transactions, and associated customer funds, insofar as New York law is concerned, that security interest is perfected ~~under New York law~~ (1) by control, in the case of the ~~customer~~customer's account, U.S. futures ~~contracts~~, foreign futures ~~contracts~~, securities margin, cash margin and, if a financial asset election is made, ~~the~~ cleared ~~swap transactions~~swaps, or (2) by filing, in the case of uncleared ~~swap~~

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[5] However, under the rules of each DCO, the customer's trading in ~~customer~~ transactions that are cleared through ~~a~~the DCO, and the customer's related conduct, are subject to the rules of that DCO ~~or~~and any related exchange, including the DCO's enforcement of those rules. Most customer agreements explicitly acknowledge that ~~they~~a customer's account and the transactions carried therein are subject to "applicable law," which is in turn defined to include the rules of the exchanges and DCOs involved in trading or clearing ~~any customer transaction executed under the relevant customer agreement~~the customer's transactions.

~~transactions~~swaps and, if no financial asset election is made, ~~the~~ cleared ~~swap transactions~~swaps. The control procedures will be those provided for "investment property" with respect to the customer account, U.S. futures ~~contracts~~, foreign futures ~~contracts~~, securities margin and, if a financial asset election is made, the cash margin and cleared ~~swap transactions~~swaps, and those provided for "deposit accounts" with respect to the cash margin, if no financial asset election is made. Please see Section X for a more detailed discussion of the perfection of security interests by FCMs.

5. An FCM liquidates, or closes out, the ~~customer~~customer's transactions (including U.S. futures ~~contracts~~, foreign futures ~~contracts~~ and cleared ~~swap contracts~~swaps) of a defaulting customer as principal to the DCO in order to satisfy its obligations as principal to the DCO, exercising its contractual rights under the rules of the applicable DCO to cause such liquidation, pursuant to the customer agreement (as modified by the ~~Cleared Derivatives Addendum~~CDA (as defined below) in the case of cleared ~~swap contracts~~swaps). Please see Section X.B.1 for further analysis.

~~6. An FCM calculates a single net balance due to or from a single defaulting customer by liquidating within each account class, and the resulting positive and negative amounts are then netted, as allowed by the customer agreement. Please see Section X.B.1 for additional discussion of the calculation of net balances.~~

6. An FCM (i) determines the final cash balance due to or from a defaulting customer in respect of the accounts and sub-accounts relating to each account class (U.S. futures, foreign futures and cleared swaps, as applicable) by liquidating and closing out the transactions and customer funds carried in those accounts and sub-accounts, debiting or crediting the cash balance with respect to each such account or sub-account by the net cumulative trading losses or gains realized in connection such liquidation, debiting or crediting the cash balance with respect to such account or sub-account by any other unpaid amounts in respect of such account class due to or from the customer under the customer's agreement, and debiting or crediting the cash balance with respect to such account or sub-account by any other amounts incurred by the FCM in respect of such account class in connection with its provision of services or its exercise of remedies, and (ii) aggregating the resulting cash balances for the applicable account classes to determine a single final cash balance for the customer's account.

7. The aggregation of the credit and deficit balances of the accounts and sub-accounts relating to different account classes within the customer's account is permitted under the CEA, and is consistent with the characterization of the customer's overall account with the FCM as a

single mutual, open and current account. However, if that characterization is not respected or is not extended to the aggregate balance across the accounts or sub-accounts within the customer's account, or if any property within the account is not included within that running balance, the FCM could also rely upon its setoff rights arising under the customer agreement or from other sources,[6] enforcement of the FCM's security interest in the customer's account and the transactions and customer funds carried in the account, or potentially upon a form of netting. Please see Section XI.B for additional discussion of the determination of the final cash balance.

~~7.~~8. An FCM ~~is entitled to carry~~would not be precluded from carrying out the liquidation or close-out of ~~the customer~~a defaulting customer's transactions ~~of~~ and determine the single net balance due to or from ~~a single defaulting~~ the customer, as described above in ~~Question~~points 6 and 7 above, in the contexts laid out below, as follows and as described in more detail in Section XII:

(a) Bankruptcy Code – Under the Bankruptcy Code, an FCM would be permitted, pursuant to certain "safe harbor" provisions, and notwithstanding the restrictions that would otherwise apply under the Bankruptcy Code, to ~~liquidate~~exercise its contractual rights to liquidate, terminate or accelerate the ~~customer~~defaulting customer's transactions, including the rights granted under the rules of the applicable DCO to close out U.S. futures ~~contracts~~, cleared ~~swap contracts~~swaps, and Portfolio-Margined SNCDS ~~included in any portfolio margining arrangement~~, and including instructing any foreign futures and options broker to liquidate any foreign futures ~~contracts~~ carried for the relevant customer; apply any margin held in the ~~customer~~customer's account in accordance with the CEA, the customer agreement, DCO rules and CEA rules; offset any ~~margin excess~~customer funds remaining with respect to any ~~such contract~~account or sub-account included in the customer's account against any ~~margin~~ deficit remaining with respect to any ~~such contract~~other account or sub-account included in the customer's account; and return only the net balance remaining (if any) to the customer.

However, if the customer is itself an FCM, liquidated under subchapter IV of the Bankruptcy Code, the right of the FCM to offset the balances of the accounts and sub-accounts of the defaulting customer relating to different account classes may be limited by the application of Part 190 of the CFTC's regulations.

[6] For example, in New York, a statutory right of setoff arises in certain circumstances under Section 151 of the New York Debtor and Creditor Law.

~~(a)~~(b) SIPA – A liquidation proceeding under SIPA is conducted in a manner similar to a proceeding under the Bankruptcy Code as described immediately above, except that SIPA contains provisions intended to ensure that "customer property" held by the broker or dealer is returned to or applied to the claims of customers, together with other assets of the broker-dealer, if necessary.

~~(b)~~(c) FDIA— If the FDIC is appointed as *receiver* for an insured depository institution, the FDIA would permit an FCM to exercise its contractual rights to liquidate the ~~customer~~defaulting customer's transactions as a result of the appointment of a receiver, and any rights relating to the customer margin, and to offset the rights and obligations of the customer under all qualified financial contracts ("*QFCs*~~,~~") between the FCM and that customer, including U.S. futures, cleared swaps and Portfolio-Margined SNCDS and including instructing any foreign futures and options broker to liquidate any foreign futures carried for the relevant customer, subject to a one business day delay to permit the FDIC the opportunity to exercise its right to transfer the QFCs to another insured depository institution, based solely on the fact of the receivership.[7] If the FDIC is appointed as *conservator*, the FCM cannot exercise any liquidation rights arising solely as a result of that appointment, but if the FDIC or the new institution fails to comply with its obligations in any respect that would otherwise give rise to a right to liquidate the customer transactions, the FCM would be permitted to exercise its rights to ~~liquidate~~close out the customer transactions in accordance with the customer agreement.

~~(c)~~(d) OLA – As under the FDIA, an FCM may exercise its contractual rights to liquidate, terminate, net and offset the ~~customer~~defaulting customer's transactions as a result of the appointment of a receiver, and any rights relating to the customer margin, and to offset the rights and obligations of the customer under all QFCs between the FCM and that customer, subject to a one business day delay to permit the FDIC the opportunity to exercise its right to transfer the QFC to another insured depository institution, based solely on the fact of the receivership.

~~(d)~~(e) HERA –As under the FDIA, HERA would permit an FCM to exercise its contractual rights to liquidate the ~~customer~~defaulting customer's transactions as a result of the appointment of a receiver, and any rights relating to the customer margin, and to offset the rights and obligations of the customer under all QFCs between the

[7] The stays under the FDIA and the OLA become permanent if the QFCs are, in fact, transferred to a bridge or other solvent entity.

FCM and that customer, subject to a one business day delay to permit the receiver the opportunity to exercise its right to transfer the QFC to a life-limited regulated entity ("*LLRE*~~"), which~~"). However, the LLRE has the power to obtain credit that is secured by a senior or equal lien on assets already encumbered to secure other obligations, including QFCs, ~~provided~~if the LLRE is unable to obtain credit otherwise on commercially reasonable terms and there is "adequate protection" of the earlier lien holders.

~~(e)~~(f) Specified State Insurance Insolvency Regimes – Under the state insurance insolvency laws of Covered Insurance Jurisdictions, in the event formal delinquency proceedings (*i.e.*, rehabilitation or liquidation proceedings) are commenced against a ~~Covered Insurance Company~~defaulting covered insurance company, an FCM would be permitted, notwithstanding the restrictions that would otherwise apply under the Covered Insurance Jurisdiction's insurance insolvency laws, to liquidate the ~~customer~~defaulting customer's transactions, including U.S. futures ~~contracts~~, cleared ~~swap contracts~~swaps, and Portfolio-Margined SNCDS ~~included in any portfolio margining arrangement~~, and including instructing any foreign futures and options broker to liquidate any foreign futures ~~contracts~~ carried for the relevant customer; apply any margin held in the ~~customer~~customer's account in accordance with the CEA, the customer ~~contract~~agreement, DCO rules and CEA rules; offset (provided the FCM is organized under the laws of the United States or an otherwise eligible foreign jurisdiction) any ~~margin excess~~customer funds remaining with respect to any ~~of such contracts~~account or sub-account included in the customer's account against any ~~margin~~ deficit remaining with respect to any ~~of such contracts~~other account or sub-account included in the customer's account; and return only the net balance remaining (if any) to the customer.

~~8.~~ An ~~FCM is entitled to set off or apply any customer funds held with respect to one account class carried in the customer account after the liquidation of the customer transactions within that account class against any obligations of the customer that remain outstanding after the liquidation of the customer transactions in any other account class by exercising its security interest in an amount due to the customer as applicable and as allowed by the customer agreement or other agreements between the customer, the FCM and/or the~~ uncleared swaps affiliate~~, as applicable. Please see Section XI for additional discussion of the calculation of net balances.~~

9. An FCM is entitledpermitted to exercise the rights described in Question 8 above in the contexts laid out below as follows and described in more detail in Section XII:

(f) Bankruptcy Code – An FCM cannot exercise these rights under the Bankruptcy Code. Part 190[8] provides that customer property relating to any account class (futures contracts, foreign futures contracts, cleared swap contracts, and delivery account classes) may be shared only by customers of that account class.

(g) SIPA – These rights are not discussed under the SIPA regime.

(h) FDIA – An FCM is entitled to exercise these rights under the FDIA. Unlike under the Bankruptcy Code, the FDIA applies safe harbors to all QFCs as a single category. The FDIA defines the term "qualified financial contract" to mean "any securities contract, commodity contract, forward contract, repurchase agreement, swap agreement, and any similar agreement that the [FDIC] determines by regulation."

(i) OLA – As under the FDIA, OLA applies safe harbors to all QFCs as a single category and defines QFC in a substantially similar manner to the FDIA.

(j) HERA – As under the FDIA, HERA applies safe harbors to all QFCs as a single category and defines QFC in a substantially similar manner to the FDIA.

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[8] On April 14, 2020, the CFTC voted unanimously to approve proposed rulemaking to amend the Part 190 regulations, intended to "comprehensively update [Part 190] to reflect current market practices and lessons learned from past commodity broker bankruptcies," and address the policies and procedures that would govern an FCM or DCO bankruptcy (Bankruptcy Regulations, 85 Fed. Reg. 36,000, (June 12, 2020) (to be codified at 17 C.F.R. pt. 1, 4, 41, 190)). The amendments include the following major changes: (1) support of the requirements of section 4d of the CEA that shortfalls in segregated property should be made up from the FCM's general assets; (2) affirming that with respect to customer property, public customers are favored over non-public customers; (3) fostering the policy preference for transferring (as opposed to liquidating) positions of public customers and those customers' proportionate share of associated collateral; (4) a new subpart C governing the bankruptcy of a clearing organization, which (i) instructs trustees to follow the DCO's pre-existing default management rules and procedures, (ii) provides that resources that are intended to flow through to members as part of daily settlement (including both daily variation payments and default resources) should be devoted to that purpose, rather than to the general estate, and (iii) draws from those provisions applicable to FCMs; (5) noting the applicability of part 190 to FCMs subject to a SIPA proceeding or where the Federal Deposit Insurance Corporation ("*FDIC*") is acting as a receiver; (6) providing that customers who post letters of credit as collateral suffer the same proportional loss as customers who post other types of collateral; and (7) granting trustees enhanced discretion in a number of areas.

~~(k) Specified State Insurance Insolvency Regimes – As under the FDIA, the insurance insolvency laws of the Covered Insurance Jurisdictions apply safe harbors to all QFCs as a single category and generally define QFC in a substantially similar manner to the FDIA; however, rights to setoff are available only to an FCM organized under the laws of the United States or an otherwise eligible foreign jurisdiction.~~

~~10.~~9. ~~An uncleared swaps affiliate is entitled to exercise its~~its contractual rights in connection with a security interest granted to it by a customer in the ~~amount~~customer's account and the credit balance (if any) payable by the FCM to the customer after liquidation of the customer's ~~cleared customer~~ transactions, including any remaining margin held by the FCM for that customer, to secure the customer's obligations under the uncleared swaps between the customer and the uncleared swaps affiliate ~~as a result of the customer's default so long as such right is provided in the customer agreement, tri-party agreement or other such agreement. Please see Section XI~~. Please see Sections IX and XI for additional discussion of the rights of the uncleared swaps affiliate.

~~11.~~10. ~~An FCM is entitled to exercise~~An uncleared swap affiliate is not precluded from exercising the rights described in ~~Question 10~~point 9 above, in the contexts laid out below, as follows and as described in more detail in Section ~~XII:~~ XII:

(a) Bankruptcy Code – An uncleared swaps affiliate is ~~entitled~~permitted to exercise its contractual rights in connection with such a security interest~~,~~ (subject to any limitations in the contract) to liquidate the customer's account and the related credit balance and apply the proceeds to any amount due from the customer under the secured uncleared swaps to the same extent that it may liquidate and apply other collateral ~~(including~~securing the ~~amounts due from~~uncleared swaps.

(b) SIPA – SIPA contains safe harbor provisions that permit the ~~FCM), net the payment~~liquidation and application of collateral to obligations of the ~~two parties arising from the foregoing, and pay or receive only the net~~debtor under swap agreements similar to those under the Bankruptcy Code.

~~(a)~~(c) FDIA – An uncleared swaps affiliate is permitted to exercise its contractual rights in connection with such a security interest (subject to any limitations in the contract) to liquidate the customer's account and the related credit balance and apply the proceeds to any amount due ~~to or~~ from the customer~~.~~ under the

secured uncleared swaps to the same extent that it may liquidate and apply other collateral securing the uncleared swaps.

~~(b) SIPA – These rights are not discussed under the SIPA regime.~~

~~(c) FDIA – The treatment of an uncleared swaps affiliate's security interest in a customer's customer account with an affiliated FCM under the FDIA would be similar to the treatment of such an interest under the Bankruptcy Code, subject to the limitations imposed by the FDIA but for the safe harbors established for QFCs.~~

(d) OLA – The treatment of an uncleared swaps affiliate's security interest in a customer's ~~customer~~ account with an affiliated FCM under the OLA would be similar to the treatment of such an interest under the FDIA~~, subject to the limitations imposed by the OLA but for the safe harbors established for QFCs~~.

(e) HERA – The treatment of an uncleared swaps affiliate's security interest in a customer's ~~customer~~ account with an affiliated FCM under the HERA would be similar to the treatment of such an interest under the FDIA~~, subject to the limitations imposed by HERA but for the safe harbors established for QFCs~~.

(f) Specified State Insurance Insolvency Regimes – The treatment of an uncleared swaps affiliate's security interest in a customer's ~~customer~~ account with an affiliated FCM under the insurance insolvency laws of the Covered Insurance Jurisdictions would generally be similar to the treatment of such an interest under the Bankruptcy Code, subject to the limitations imposed by such laws ~~but for the safe harbors established for QFCs~~.

IV. BACKGROUND

We have prepared the following discussion and the other descriptions of FCM and industry practices based on our discussions with members of the Futures Industry Association (the "*FIA*") and the International Swaps and Derivatives Association ("*ISDA*") and its other counsel. To the extent that the description below and elsewhere in this memorandum describes the practices of FCMs, foreign futures brokers, DCOs and other parties in clearing U.S. futures, cleared swaps and foreign futures, and in operating customer accounts, we are assuming that the description accurately describes those practices, and the analysis in this memorandum is based upon the following facts and assumptions.

A. Customer Agreements

An FCM is a broker that, among other things, clears transactions through a DCO on behalf of its customers. "Clearing" refers to the process by which a bilateral contract between two parties is novated to a clearing organization, such as a DCO, such that the single original transaction is replaced with two new offsetting transactions, with the clearing organization interposed between the original parties.[9] Only clearing members may clear transactions with a clearing organization; if a party executing a transaction is not a clearing member, then it must become a customer of an FCM who is a clearing member (or of another FCM that clears customer trades through another FCM that is a clearing member).[10] The FCM submits the transaction to the clearing organization for clearing on behalf of its customer, and holds – or "carries" – the transaction between itself and the clearing organization for the benefit of that customer, reflecting the customer's position in the transaction in an account maintained for the customer.[11]

The FCM, as a member of the DCO and the entity directly facing the DCO on each transaction, agrees in its agreement with the DCO to abide by certain terms and the rules of the DCO. The FCM in turn requires each customer to enter into a customer agreement before establishing accounts and clearing and carrying transactions on behalf of that customer. Pursuant to the terms of the customer agreement, the FCM establishes one or more accounts on its books and records in the customer's name (individually or collectively, the "*customer account*"), and the customer authorizes the FCM to execute, carry and clear transactions for the purchase and sale of U.S. futures, foreign futures and/or cleared swaps on behalf of the customer. The effect of this authorization, and the FCM's acceptance, is to cause the FCM to become the customer's agent for these purposes.

Under the customer agreement, and consistent with its role as the customer's agent, the FCM is required to account to the customer for the profits and losses derived from the customer's transactions. To the extent that the transactions carried by the FCM for the customer generate profits, the FCM is required to account for those profits to the customer; to the extent that they generate losses, the customer is required to make the FCM whole for those losses. The FCM must credit all customer

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[9] The term "clearing" means "[t]he procedure through which the clearing organization becomes the buyer to each seller of a futures contract or other derivative, and the seller to each buyer for clearing members." *See* CFTC Glossary, *available at* https://www.cftc.gov/LearnAndProtect/EducationCenter/CFTCGlossary/glossary_c.html.

[10] James T. Moser, *Contracting Innovations and the Evolution of Clearing and Settlement Methods at Futures Exchanges*, Working Papers Series Research Department (WP-98-26), Federal Reserve Bank of Chicago (Aug. 1998), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=910505.

[11] Although there are other means of "clearing" transactions, all major U.S. futures exchanges currently use this novation method – known as "complete clearing" – to clear U.S. futures and cleared swaps. *See* https://www.cmegroup.com/clearing.html (CME); https://www.cmegroup.com/company/membership/clearing/cbot.html (CBOT); https://www.lch.com/services/swapclear/essentials (LCH); https://www.theice.com/publicdocs/How_Clearing_Works.pdf (ICE).

funds received from the customer as margin or otherwise in connection with its transactions, and any accruals or proceeds received in respect of the transactions or other property held for the customer, to the customer account. In its turn, the customer agrees in its customer agreement to (i) deposit and maintain margin with the FCM, (ii) pay the FCM the amount of any trading losses, debit balances or deficiencies (and any applicable interest on those amounts), premiums on options purchased for the customer, brokerage charges and commissions owed to or incurred by the FCM, charges imposed by exchanges or other SROs relating to the customer's transactions or account, and other costs arising in the course of the customer's relationship with the FCM (and the customer agreement authorizes the FCM to debit the customer account for any of these amounts) and (iii) reimburse or indemnify the FCM for any costs or liabilities incurred by the FCM in the course of providing services or exercising remedies under the customer agreement. The customer agreement specifies the fees, expenses or other obligations for which the customer is responsible, and authorizes the FCM to deduct them from the customer's account.

Each FCM has its own default "in-house" customer agreement (there is no standard form across the industry). However, each customer agreement will include the provisions described above authorizing the FCM to clear and carry transactions on behalf of the customer and addressing certain principal rights and obligations of the customer, including the customer's obligation to satisfy all margin requirements and other payment obligations and comply with applicable position limits and exchange and DCO rules. In addition, the customer agreement typically includes a grant by the customer of a security interest in, lien on and right of setoff in respect of the customer's account and the transactions and customer funds carried or credited to in the account; certain provisions providing protections to the FCM, including limitations on liability, events of default and remedies, among others; and provisions for the optional termination of the customer agreement by the FCM or the customer. The customer agreement typically provides that the customer account and the customer's transactions are subject to "applicable law," which is generally defined to include applicable US legislation, rules, regulations and interpretations of regulatory agencies and self-regulatory organizations ("*SROs*") and the rules of trading venues (including exchanges) and clearing organizations where the customer's transactions are executed and cleared.

A customer agreement generally consists of (i) a customer account agreement (a "*base account agreement*") based on the FCM's in-house form, if the customer is trading only U.S. futures and foreign futures, (ii) a base account agreement with a cleared derivatives addendum ("*CDA*"), if the customer is trading only cleared swaps or both U.S. futures or foreign futures and cleared swaps, and (iii) one or more other documents relating to the terms of the relationship between the FCM and the customer. The CDA is intended to serve as an addendum to a base account agreement, and all of these documents together form a single agreement that governs the customer's account.

The requirements applicable to cleared swaps differ from those futures transactions in certain key respects (*i.e.*, margin calculations, requirements and permitted

collateral) such that additional documentation is needed in order to properly address swap transactions. For reasons of efficiency, FCMs typically use the same customer agreements to cover cleared swaps as they do for cleared futures transactions, with additional terms to address these cleared swaps-specific requirements. In order to standardize the market's approach, FIA and ISDA developed the CDA to supplement the customer agreement to document the relationship between a clearing member and its customer for purposes of clearing cleared swaps.[12] The CDA includes representations regarding certain clearing-related matters, such as the treatment of customer collateral and representations for both the customer and the FCM with respect to swaps clearing matters.[13] The CDA also details close-out methodology for cleared swaps, liquidation triggers,[14] and provisions for valuing the terminated trades and tax issues, as described in more detail below. As noted above, the CDA is considered part of the FCM customer agreement and the agreement and CDA, taken together, constitute a single agreement.

As described in more detail in Sections I and VII below, a customer may not always have a direct relationship with an FCM. A customer may transact through another broker that in turn transacts with an FCM to execute transactions. In such a case, the parties often enter into a "give up" agreement (a "*Futures Execution Agreement*"), pursuant to which the executing broker confirms that it will "give up" all executed trades to the FCM as the clearing broker that transacts with the DCO. The Futures Industry Association (the "*FIA*") has developed an industry standard Futures Execution Agreement.[15] The Futures Execution Agreement may also determine the fees that will be required to each of the broker and the FCM.

Events of default applicable to the customer and related remedial provisions are set out in both the base account agreement and, if applicable, the CDA. A customer agreement has no specified term, but may be terminated by either party by written notice. If either party delivers notice of termination of the customer agreement (other than as a result of a customer default), the customer must promptly instruct the FCM to close its open transactions or arrange their transfer to another FCM; if the customer fails to do so, the FCM is entitled to liquidate the customer's open positions and any other property credited to the account.

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12 In 2018, FIA and ISDA published an Alternative FIA-ISDA Cleared Derivatives Addendum, which is an optional template that provides an alternative to the Cleared Derivatives Addendum (but does not replace or supersede it).

13 *See Form of Addendum, Cleared Derivatives Transactions*, FUTURES INDUS. ASS'N & INT'L SWAPS AND DERIVATIVES ASS'N § 2, *available at* https://www.fia.org/sites/default/files/2019-05/FORM%20OF%20ADDENDUM%20CLEARED%20DERIVATIVES%20TRANSACTIONS%208085.pdf.

14 *See id.* § 7.

15 *2017 Standard Give-Up Agreements*, FUTURES INDUS. ASS'N, *available at* https://www.fiadocumentation.org/fia/pages/new-standard-give-up-agreements.

B. Customer Accounts and Account Classes

The FCM records in the customer's account all the transactions cleared by the FCM on behalf of the Customer, as well as debits and credits reflecting margin deposited by or excess margin released to the Customer, realized and unrealized gains and losses on the customer's transactions, interest or other income on margin held in the account, net option values, commissions, amounts payable to introducing brokers, costs relating to physical settlement, fees and other amounts due to or from the customer in respect of the account, and any other amounts that may be credited or debited to the account under the customer agreement.

The CFTC's rules governing U.S. futures, foreign futures and cleared swaps establish separate regulatory frameworks for each of those product classes, establishing different requirements with respect to the execution of transactions, the clearing process, documentation, reporting and other matters. In addition, the CFTC's rules with respect to the treatment of cash, securities and other property (collectively, "*funds*") received by the FCM to margin customer transactions, or accruing to customers as the result of their transactions (collectively, "*customer funds*"[16] require the FCM to segregate or set aside those customer funds based on the product classes to which they relate (*i.e.*, U.S. futures, cleared swaps or foreign futures) and, as a general matter, prohibit commingling of customer funds segregated or set aside for one product class with customer funds segregated or set aside in respect of any other product class, or with the FCM's proprietary funds (except to the extent of the FCM's residual interest, as described in Section **I**). To ensure that the books and records of the FCM reflect segregation consistent with these rules, if the customer clears multiple products, it is treated as having a separate account or sub-account for each product within its customer account. Accordingly, as used in this memorandum, (i) the "*U.S. futures account*," "*cleared swaps account*" and "*foreign futures account*" refer to the entries on the FCM's books and records pertaining to the U.S. futures customer funds, cleared swaps customer funds or foreign futures customer funds, respectively, of the customer, (ii) "*account class*" means the customer's U.S. futures account, cleared swaps account or foreign futures account and (iii) "*customer account*" or "*account*" may refer, as the context

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16 "Customer funds" include futures customer funds and all Cleared Swaps Customer Collateral. "Futures customer funds" include all money, securities, and property received by a futures commission merchant or by a DCO from, for, or on behalf of, futures customers to margin, guarantee, or secure contracts for future delivery on or subject to the rules of a contract market or DCO, as the case may be, and all money accruing to such futures customers as the result of such contracts; in connection with a commodity option transaction on or subject to the rules of a contract market, or derivatives clearing organization, as the case may be, to be used as a premium for the purchase of a commodity option transaction for a futures customer; as a premium payable to a futures customer; to guarantee or secure performance of a commodity option by a futures customer; or representing accruals to a futures customer. 17 C.F.R. § 1.3. Cleared Swaps Customer Collateral includes the corresponding amounts for cleared swaps. *Id.* § 22.1.

requires, to any account class or all account classes on a combined basis maintained for a customer under a customer agreement.

The customer agreement establishes the customer account as a mutual, open and running account, or mutual open account, between the customer and the FCM. A mutual open account is an account in which, by agreement of the parties, a connected series of debit and credit entries of reciprocal[17] charges and allowances is to be recorded, and the parties intend that the individual items of the account, once applied to the account, will not be considered independently, but as a continuation of a related series, such that the account balance will increase and decrease as additional related debits and credits are entered and change the account balance until either party wishes to settle and close the account.[18] In other words, as customer funds are credited to the account (whether as margin deposited by, or as gains accruing to, the customer), and customer funds are debited from the account (whether as charges payable by the customer or withdrawals to return customer funds to the customer or deliver them to another party), the balance of the account increases or decreases.

Moreover, consistent with the common-law view that an account constitutes a claim or demand by one person against another creating a debtor-creditor relationship,[19] the parties intend that the account represent one single indivisible liability, represented by the account's balance, owed by one party, as debtor, to the other, as creditor, arising from the series of related and reciprocal debits and credits.[20] Like many other types of account agreements, the customer agreement generally provides no details as to the operation of the account or the method by which balances are determined, either pre- or post-default, but such matters may be inferred from both the customs and practices of the industry, the nature of the relationship between the customer and the FCM and the customer margining standards discussed below, to which the account is subject.[21] This balance – the account's "net liquidating equity" – determines, among other

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17 In other words, the entries must reflect obligations that are mutual – between the same two parties.

18 *See Refco, Inc.* v. *Farm Production Ass'n, Inc.*, 844 F.2d 525 (8th Cir. 1987) (applying Arkansas law); *Seibert's Assignee* v. *Albritton*, 19 Ky. L. Rptr. 402 (1897) (applying Kentucky law); *cf. Abbay* v. *Hill*, 64 Miss. 340 (1887) (relating to a commission merchant); *In re Cipriano*, 2015 WL 3441212 (E.D. Mich. 2015) (relating to a merchant under the Perishable Agricultural Commodities Act). A mutual, open and running account gives rise to a single cause of action for the balance, *see Banner Grain Co.* v. *Burr Farmers' Elevator & Supply Co.*, 162 Minn. 334 (1925).

19 *See Greer Limestone Co.* v. *Nestor*, 332 S.E. 2d 589 (W.Va. 1985) ("We have defined the term 'account' to be 'a claim or demand by one person against another creating a debtor-creditor relation.'").

20 This intention applies both to the transactions executed within a single account class, as discussed below, and across account classes, because there is a single business relationship between the FCM and customer with respect to all account classes, and a single account maintained for the customer under the customer agreement, of which all account classes form a part.

21 The account is subject to these requirements both by law and regulation, which mandate these aspects of the manner in which customer accounts are managed, and by the customer agreement, which (as noted above) is expressly made subject to "applicable law" and frequently contains an express acknowledgement of the margin requirements specifically.

things, when the FCM must call for initial and maintenance margin, when the FCM may disburse excess margin upon the customer's request and how much the FCM must segregate or set aside pursuant to the segregation requirements discussed below. It also serves as the basis for calculating the FCM's claim against the customer in the event of the customer's default, and the customer's claim in the FCM's bankruptcy under the Bankruptcy Code and the related regulations of the CFTC.

Similar rules apply to a customer's foreign futures account. However, these rules derive from a different source under the CEA, and historically operated somewhat differently. Rather than requiring "segregation" of customer funds relating to foreign futures, an FCM is required to establish a "separate account" for such transactions. However, in 2013, the separate account rules applicable to foreign futures were largely conformed to the segregation requirements for U.S. futures and cleared swaps. All three sets of requirements are referred to in this memorandum as the "*customer property rules*."

Under CFTC rules, for purposes of determining the amount that the FCM must segregate or set aside, the customer's net liquidating equity is equal to the market value of any customer funds that the FCM receives from the customer, as adjusted by (i) any Permitted Uses (as defined in Section VI.B), (ii) any accruals on permitted investments of such customer funds that, pursuant to the customer agreement, are creditable to the customer, (iii) any unrealized gains and losses with respect to the customer's contracts, (iv) any charges lawfully accruing to the customer, including any commission, brokerage fee, interest, tax or storage fee, and (v) any appropriately authorized distribution or transfer of such customer funds. In practice, the net liquidating equity reflected in a customer account is determined in accordance with customer margining standards (the "*margining standards*") established by a representative committee of SROs, including the National Futures Association and U.S. futures exchanges, that participate in a joint audit and financial surveillance program with respect to FCMs that has been approved and is overseen by the CFTC.[22] The margining standards (which address, among other things, when the FCM must call for margin, how excess margin is calculated, when it may be disbursed to the customer and how to compute net liquidating equity for margining purposes) represent "applicable law" to which the customer account and contracts are subject, as described in Section VI.A above, and operate together with the provisions of customer agreements relating to customer margin, payment, reimbursement and indemnification obligations to establish the customer's contractual rights to amounts payable to it under its customer agreement.

C. Omnibus Accounts

When an FCM becomes a clearing member of a DCO, the DCO establishes accounts for the FCM for each account class cleared by the FCM with that DCO. These accounts include a proprietary positions account to which the DCO credits proprietary transactions cleared by the FCM, and an omnibus customer positions account

[22] This committee is referred to as the "*Joint Audit Committee*."

maintained in the name of the FCM for the benefit of its customers in the relevant account class, to which it credits transactions cleared by the FCM for its customer. When the FCM clears a U.S. future or cleared swap for a customer, the DCO credits the transaction to an omnibus customer positions account of the FCM at the DCO. The FCM, in turn, credits the transaction to the customer's account on the FCM's books. Similarly, in the case of the customer's foreign futures, the foreign futures broker clears the transaction with the relevant foreign clearing organization, which credits the transaction to an omnibus account with the foreign clearing organization maintained in the name of the foreign futures broker for its customers, and the foreign futures broker, in turn, credits the transaction to an omnibus customer positions account of the FCM with the foreign futures broker maintained in the name of the FCM for the benefit of its foreign futures customers. The FCM, in turn, credits the transaction to the customer's account on the FCM's books.

Accordingly, for every transaction, there are at least two relevant accounts: (i) the customer's account on the FCM's books in the name of the specific customer to which the FCM credits all transactions cleared for the customer by that FCM across all DCOs or foreign clearing organizations (and which may be made up of numerous accounts or sub-accounts for different purposes), and (ii) an omnibus customer positions account of the FCM at the applicable DCO, or foreign futures broker, to which the FCM's customer transactions for all its customers in the relevant account class at that DCO, or foreign futures broker, are credited.

In parallel, the DCO establishes omnibus accounts to hold the customer funds delivered to the DCO by the FCM – proprietary margin accounts in which the DCO holds the customer funds relating to proprietary positions, and omnibus customer margin accounts in which the DCO holds customer funds relating to customer positions. If the FCM transfers customer funds to the DCO for credit to the FCM's omnibus customer margin account, the DCO must hold the customer funds in the DCO's omnibus account for its FCM customers; the DCO, in turn, must acknowledge that the funds are funds of the FCM's customers, and hold the margin in permitted depositaries in accounts complying with requirements corresponding to those applicable to the FCM's own segregated accounts.[23]

The structure of the omnibus customer positions account in the case of cleared swaps is the same as in the case of futures. However, the FCM is required to provide the DCO, no less frequently than once each business day, information sufficient to identify, for each Cleared Swaps customer, the portfolio of rights and obligations

[23] 17 C.F.R. §§ 1.20; 22.3 (2020). Securities deposited with an FCM as margin by a customer may be deposited by that FCM with a DCO that does not clear that customer's transactions (so long as the customer's transactions and the transactions at the DCO secured by the customer's securities are in the same account class) or the securities may be rehypothecated by the FCM for cash under a repo agreement (provided the FCM maintains such cash in segregation). 17 C.F.R. § 1.20.

arising from the Cleared Swaps that such FCM intermediates for the customer.[24] In addition, the DCO must maintain records, updated no less frequently than once each business day, of (1) the amount of margin required at such DCO for each Cleared Swaps customer of the relevant FCM; and (2) the sum of the all such amounts for all customers of such FCM.[25] The DCO is obligated to treat the value of the customer funds received from each cleared swaps customer as belonging to that specific cleared swaps customer.[26] However, this treatment does not limit the DCO's right to liquidate any or all positions in the omnibus customer positions account upon the default of the FCM and apply any or all margin relating to all customers to any related obligations of the FCM in respect of those positions. As a result, although the customer funds of the various customers are commingled in a single omnibus account, they are "legally segregated" by the maintenance of records and rules that allow the DCO and the FMC to track the value of customer funds allocable to each customer, and ensure that the funds of one customer are not used to satisfy the obligations arising out of cleared swaps allocable to another customer.

D. Margining and Operation of the Customer Account

Margining of U.S. futures and cleared futures is a critical element of these transactions.[27] When the FCM establishes an open position for the customer in a U.S. future or cleared swaps cleared by a DCO, the FCM will be required to satisfy the DCO's initial margin requirement for the position. If, at any time at or following the establishment of the open position, the FCM holds insufficient funds of the customer to fully cover the DCO's margin requirement, the FCM will be required to use its own funds, and then to obtain additional margin in the requisite amount from the customer. If the open position is closed, the FCM is no longer required to maintain initial margin for it, and unless the funds are needed to margin other positions in the same account class cleared by the FCM with the DCO, the DCO will return any initial margin it holds with respect to that position to the FCM's segregated account at the settlement bank that it uses in connection with that DCO.[28]

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[24] *Id.* § 22.11(c)(2).

[25] *Id.* § 22.12(c).

[26] *Id.* § 22.15.

[27] Margining in respect of foreign futures is governed by the law governing the clearing organization or contract in question. An FCM provides customer funds to a foreign futures broker that the foreign futures broker uses to margin foreign futures. Because the process of margining these contracts is not governed by New York or federal law and varies depending on the relevant governing regime, we have not attempted to describe the process here.

[28] A DCO will calculate initial margin in respect of an omnibus customer positions account on a "gross" basis equal to the sum of the initial margin amounts that would be required by the DCO for each individual customer within that account as if each customer were a clearing member. However, the DCO and FCM will settle *futures* initial margin amounts due on the same day on a net basis, such that initial margin amounts due from customers will be netted against initial margin amounts being released by the DCO to other customers. In contrast, *cleared swaps* initial margin amounts are settled on a gross basis. The FCM's customers are divided into those whose initial

For each open position of the customer in a transaction in respect of which the DCO and FCM exchange variation margin amounts,[29] the DCO will (i) at the end of each trading day, mark to market the position and determine a variation margin amount payable by the DCO to the FCM (or by the FCM to the DCO) equal to any trading gains (or losses) in respect of the position for that trading day,[30] (ii) net that variation margin amount with all other variation margin amounts for all other open positions of the customer and all other customers in the same account class cleared by the FCM at the DCO, and (iii) at or before the opening of the next trading day, deposit to or withdraw from the FCM's segregated account at its settlement bank the resulting aggregate net variation margin amount. DCOs are authorized to credit or debit variation margin payments from the FCM's segregated account without further action or authorization by the FCM; accordingly, this process occurs without the involvement of the FCM. Any other DCO clearing the customer's open positions in the same account class will conduct a similar variation margin settlement process. Because all these debits and credits are made by each DCO to the FCM's segregated funds account, the variation margin amounts credited by one DCO to the FCM's segregated account in respect of the net gains on the customer's open positions with the DCO may be used to satisfy variation margin amounts for which another DCO debits the segregated account in respect of net losses on open positions it clears. The netting of variation margin amounts due to a DCO (in respect of trading losses) and from the same DCO (in respect of trading gains) in respect of the customer's open positions in contracts cleared by the DCO, and the use of variation margin amounts received from one DCO (in respect of net trading gains) and to satisfy variation margin requirements payable to another DCO (in respect of net trading

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margin requirements have increased and those whose initial margin requirements have decreased since the prior day, and the FCM must deposit with the DCO the aggregate of the increased initial margin amounts before it is permitted to withdraw the aggregate of the released initial margin amounts.

[29] The DCO and FCM exchange variation margin amounts with respect to all cleared swaps and U.S. futures, with the exception of certain than options on futures that use "equity-style" margining. No variation margin amounts are paid in respect of options with "equity-style" margining prior to the exercise of the options. An upfront premium on an equity-style option is paid from the buyer to the seller (via the DCO) when the option is traded, and the buyer receives a credit net liquidating value ("*NLV*"), equal to the current replacement value of the option, which the buyer can use as collateral to satisfy its initial margin requirements or offset any debit NLV on other equity-style options. Upon receipt of the upfront premium, the seller receives a debit NLV that must be covered by collateral, being either any credit NLV on other equity-style options or cash, securities or other collateral. The value of the NLV – both debit and credit – varies each day with the current fair value of the option. If the option is exercised, the buyer receives the underlying future, and the final NLV becomes the variation margin amount on the resulting futures position. In contrast, for an option on a future with "futures-style" margining, a premium is paid only upon exercise/expiry, not upfront on the trade date, there is no NLV and variation margin amounts are paid on a daily basis during the life of the option.

[30] Variation margin amounts exchanged by a DCO and FCM in respect of U.S. futures and cleared swaps constitute settlement payments that extinguish mark-to-market exposures, rather than transfers of collateral that secure such exposures. However, daily settlement by the FCM and DCO of variation margin amounts in respect of open positions does not result in the positions being considered settled or closed.

losses) in respect of the customer's open positions in contracts cleared by each DCO constitute Permitted Uses of customer funds to satisfy the customer's obligations.

1. Example of Margining Between the FCM and Customer in Respect of U.S. Futures and Cleared Swaps

If the customer's net liquidating equity is less than the applicable margin requirement for its account, the account is undermargined, and the FCM will call for the customer to deposit with the FCM additional funds so that the customer's net liquidating equity at least equals the customer account's initial margin requirement.[31] When the customer meets the margin call, the funds will be deposited in one of the FCM's segregated accounts for the applicable account class at one of the FCM's settlement banks, and the FCM will credit the customer's deposit to the cash balance (and/or the non-cash margin balance) of the customer account (which will increase the liability of the FCM to the customer and the customer's net liquidating equity claim against the FCM's segregated funds for such account class). The FCM must continue to hold the funds with permitted depositories, as described in VI.B, including in the FCM's omnibus customer margin accounts for customers of the relevant account class on the books of one or more DCOs. Each of the cash and non-cash balances represents funds deposited by the customer with the FCM and is not adjusted when the FCM deposits initial margin with a DCO, or when the DCO releases initial margin to the FCM, as a result of establishing or closing positions in the customer's contracts cleared through the DCO.

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[31] For purposes of determining when the customer must provide additional margin, the customer's net liquidating equity is equal to the sum of (i) the account's "*open trade equity*" with respect to open positions in transactions in respect of which the FCM and DCO exchange variation margin amounts (which include futures, cleared swaps and options with "futures-style" margining), (ii) the account's cash balance, (iii) the collateral value of non-cash margin and (iv) for the FCM that does not use the "total equity" method for margining, net option value ("*NOV*") of options in respect of which no daily variation margin amounts are exchanged. A "total equity" method FCM, for margining purposes, does not include NOV in net liquidating equity, and changes in NOV instead result in adjustments to the customer's initial margin requirement. Open trade equity represents the net cumulative "unrealized" gains and losses in respect of the customer's positions while they are open (*i.e.*, the open trade equity of an open position as of any date reflects the net cumulative gain or loss in respect of the position for the period from the establishment of the position to such date). When the position is closed, the net cumulative gain or loss represented by open trade equity is "realized" by the customer and the position's open trade equity (which may be less than zero) either increases or decreases the cash balance of the Customer Account (and thereafter is no longer reflected in the account's open trade equity). The cash balance is increased by, among other things, (1) cash deposited by the customer as margin with the FCM, (2) the net cumulative gains realized in respect of the customer's positions with open trade equity when they are closed (which equals the positions' net positive open trade equity immediately prior to their closure) and (3) any other amounts payable to the customer under the customer agreement and is decreased by, among other things, (A) the net cumulative losses realized in respect of the customer's positions with open trade equity when they are closed (which equals the positions' net negative open trade equity immediately prior to their closure), (B) any permitted withdrawals of excess cash margin from the account by the customer and (C) commissions, brokerage fees, taxes, interest and other charges to the Account.

The FCM may call for initial margin from the customer in respect of a position in an amount greater than the amount of initial margin that the relevant DCO requires from the FCM in respect of the position. The FCM will generally maintain the excess margin in its segregated account(s) at the FCM's settlement bank(s), but may also deposit the excess margin with other permitted depositories, including a DCO.

When the FCM establishes an open position for the customer in a contract in respect of which variation margin amounts are exchanged between the FCM and DCO,[32] until the position is closed, daily trading gains or losses will increase or decrease the position's open trade equity reflected in the customer's account, which will represent the net cumulative (*i.e.*, life-to-date) "unrealized" gain or loss in respect of the position. Unrealized gains and losses will not change the customer's cash balance, but will increase or decrease open trade equity (and the account's net liquidating equity), and increases in open trade equity resulting from unrealized gains represents "settled cash" that can support new trading.[33] When the position is closed, the cumulative net trading gain or loss reflected in the position's open trade equity will be "realized" and the FCM will credit or debit the cash balance of the customer account by the amount of the position's open trade equity (and thereafter no open trade equity will be reflected in respect of the closed position). In addition, when the position is closed, the aggregate initial margin requirement applicable to the customer account will be reduced by the amount of initial margin the customer was required by the FCM to maintain in respect of the position.

2. Implications of Margining Practices and Regulations in Respect of Customer Entitlements

To the extent the customer account's net liquidating equity exceeds the initial margin requirement for the account, taking into account all open positions, such excess margin amount constitutes "*free funds*" available for withdrawal by the customer upon its request. When free funds are disbursed to the customer, the amount of the disbursement is debited from the customer account's cash balance (if cash is disbursed) or the non-cash margin balance (if non-cash margin is returned). Because the customer's entitlement to free funds is determined by reference to its net liquidating equity, the customer never has a claim against the FCM for payment of trading gains in respect of the customer's contracts on a contract-by-contract or gross basis.[34]

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32 *See supra* note 28.

33 For this reason, the daily settlements of variation margin amounts between the DCO and the FCM acting on behalf of its customers in respect of open positions, as discussed in Section IV.D above, do not result in adjustments of the Customers' cash balances for purposes of margining or segregation; rather, as between the Customer and the FCM, the value to the Customer of its open positions (including the net value of all historic variation margin amounts between the DCO and FCM) is accounted for as open trade equity as described in this paragraph.

34 Additionally, the CFTC's Rule 1.56 prohibits the FCM from representing in any way that it will, with respect to any commodity interest carried by the FCM for or on behalf of any person:

~~IV.~~V. ADDITIONAL ASSUMPTIONS, DISCLAIMERS AND QUALIFICATIONS

For purposes of this memorandum, we have assumed that the description of the relationship between the customer and the FCM, the customer agreements, and the operation of the customer account contained in Section IV above is true and correct in all material respects and, in addition, that each of the following statements is true and correct:

1. Each customer's U.S. futures ~~contract~~ and ~~swap contract is~~cleared swaps are cleared by an FCM through a DCO that is registered with the CFTC under Section 5b of the CEA,[35] and ~~is~~are properly reflected on the books and records of the FCM and the DCO as ~~a~~ customer ~~transaction.~~transactions. The FCM clears the U.S. futures and cleared swaps for the customer through a DCO as a direct member of the DCO, such that the FCM is interposed between the DCO and customer in the clearing chain.[36]

2. Each customer's foreign futures ~~contract is~~are cleared by a foreign broker though a foreign exchange or clearinghouse ~~(~~that is registered with the local regulator~~),~~, and each such transaction is properly reflected on the books and records of the foreign broker, the foreign exchange or the foreign clearinghouse, and (where applicable) the intermediary U.S. FCM.

3. Any FCM that engages in portfolio margining of the type described in Section VIII below is a "stockbroker" within the meaning of Section 101(53A) of the Bankruptcy Code.

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(1) guarantee such person against loss; (2) limit the loss of such person; or (3) not call for or attempt to collect initial and maintenance margin as established by the rules of the applicable exchange. To the extent a provision in a Customer Agreement entitled the Customer to gross trading gains and such provision was inconsistent with the prohibitions in Rule 1.56, it would be void.

[35] The analysis of ~~cleared customer~~ transactions in Section ~~V~~I below is limited to cleared futures contracts and cleared ~~swap contracts~~swaps that are cleared through DCOs registered under the CEA. It does not address foreign futures contracts that may be cleared through an FCM on a non-CFTC-regulated central counterparty, which are addressed in Section ~~VI~~VII below, nor does it address the Eurex Clearing AG FCM clearing service. However, for the avoidance of doubt, the analysis in Section ~~V~~I below would apply, insofar as U.S. law governs, to LCH Limited and ICE Clear Europe and their respective provision of customer clearing services to FCMs in accordance with CFTC regulations.

[36] In some cases, a customer maintains a customer account with an FCM that is not a clearing member. In that event, the clearing FCM's customer is the intermediary FCM with which the customer maintains the customer account, or another intermediary FCM that holds an account with that intermediary FCM. This memorandum does not address such intermediary FCM relationships in relation to U.S. futures and cleared swaps.

4. Any SNCDS portfolio margining arrangement complies with the rules, requirements, guidance or interpretation established by the Securities and Exchange Commission (the "*SEC*~~")~~") and the CFTC to govern such arrangements in the SEC Exemptive Order ~~dated December 14, 2012~~published in the Federal Register on November 5, 2021 (the "*2021 SEC Exemptive Order*")[37] and in SEC and CFTC orders and letters, such as the CFTC's order issued to ICE Clear Credit, LLC ("*ICE Clear Credit*") dated January- 14, 2013, and the rules of the relevant clearinghouses.

5. Each customer transaction and the related agreements are entered into by the FCM, the customer and the DCO in the ordinary course of business, represent *bona fide* and arm's-length transactions, and are not entered into by the FCM, the customer or the DCO in contemplation of insolvency or with the intent to hinder, delay or defraud the creditors of any party or any other person, and there are no "badges of fraud" present in connection with the transactions described in this opinion.[38]

6. The agreements between the FCM, the customer, the DCO and the foreign futures broker, as applicable, governing each customer transaction, including the customer agreement, are in writing and have been duly authorized, executed and delivered by each of the parties thereto; each such agreement is within the capacity of, and constitutes the valid and legally binding obligation of, each of the parties thereto; each agreement is enforceable against each party thereto in accordance with its terms under applicable law; and all such agreements are entered into prior to the commencement of any insolvency proceedings against any of the parties.

7. The agreement granting cross-affiliate netting rights to each uncleared swaps affiliate grants to the uncleared swaps affiliate a security interest in the rights of the relevant customer against the FCM, and such security interest is a fully perfected, first-priority security interest.

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[37] SEC, Order Granting Conditional Exemptions Under the Securities Exchange Act of 1934 in Connection With the Portfolio Margining of Cleared Swaps and Security-Based Swaps That Are Credit Default Swaps, 86 Fed. Reg. 61357 (Nov. 5, 2021) [hereinafter 2021 SEC Exemptive Order].

[38] "*Badges of fraud*~~"~~" are those conditions that would cause a reasonable person to inquire further into the *bona fide* nature of the transaction, and could include conditions relating to (1) the lack or inadequacy of the consideration; (2) the family, friendship or close associate relationship between the parties to the transaction; (3) the retention of possession, benefit or use of the property in question; (4) the financial condition of the party sought to be charged both before and after the transaction in question; (5) the existence or cumulative effect of the pattern or series of transactions or course of conduct after the incurring of debt, onset of financial difficulties, or pendency or threat of suits by creditors; and (6) the general chronology of events and transactions under inquiry. *See, e.g.*, *In re Kaiser*, 722 F.2d 1574, 1582-83 (2d Cir. 1983). "Badges of fraud" may also include those factors set forth in Section 4(b) of the Uniform Voidable Transaction Act.

8. All transactions between the customer and the uncleared swaps affiliate fall within the definition of "swap agreement" set forth in Section 101 of the Bankruptcy Code, Section 1821(e) of the Federal Deposit Insurance Act, Section 1367(d)(8)(D)(vi) of HERA, Section 210(c)(8)(D)(vi) of the Dodd-Frank Act, and the insurance insolvency law of the applicable Covered Insurance Jurisdiction.

9. Each customer agreement is expressly stated to be governed by New York law, and the aggregate amount of the transactions covered by each customer agreement is $250,000 or more. Each customer agreement either does not specify the commodity intermediary's jurisdiction or securities intermediary's jurisdiction, or specifies that New York is the commodity intermediary's jurisdiction or securities intermediary's jurisdiction.

10. To the extent that any party to any agreement governing any customer transaction or other arrangement discussed in this memorandum is a bank whose deposits are insured by the FDIC under the FDIA, the bank has complied with all requirements under the FDIA or under the policies, procedures or interpretations of the FDIC to make the agreement binding and admissible in an insolvency proceeding for such bank under the FDIA.

11. The performance by each party of its obligations under each customer transaction and any agreement relating to any customer transaction, including the customer agreement, will comply with applicable law and with any requirement or restriction imposed by any court or government body having jurisdiction over such party and will not result in a default under or breach of any agreement or instrument then binding upon such party.

12. In the absence of insolvency, liquidation, cross-product liquidation and cross-affiliate liquidation provisions in the customer agreement and other documentation governing the relationship between the customer and the FCM, the customer and the uncleared swaps affiliate and (if applicable) the FCM and the uncleared swaps affiliate, are enforceable under New York law.

13. The FCM is registered as an FCM with the CFTC under the CEA.

14. The uncleared swaps affiliate is a "financial participant" within the meaning of 11 U.S.C. § 101 and is a "financial institution" within the meaning of 12 U.S.C. § 4402 or qualifies as a financial institution pursuant to Regulation EE of the Federal Reserve Board, 12 C.F.R. § 231.3.

15. In the customer agreement:

(a) The customer engages the FCM to establish one or more customer accounts in the customer's name for the purpose of executing, clearing and/or carrying customer transactions.

(b) The customer authorizes the FCM to execute, clear and carry contracts or transactions of one or more account classes (*i.e.*, U.S. futures ~~contracts~~, foreign futures ~~contracts~~ or cleared ~~swap contracts~~swaps), or to purchase and sell such contracts or transactions, through one or more DCOs or foreign clearing organizations, as applicable, on behalf of the customer in accordance with the customer's instructions, DCO rules and applicable law, and agrees to provide margin and make payments in accordance with the customer agreement, the instructions of the FCM, DCO rules and applicable law.[39]

(c) To the extent that the customer engages the FCM to clear and carry cleared ~~swap contracts~~swaps, the customer agreement incorporates or includes a ~~cleared swaps addendum~~CDA in one of the forms published, such as the ~~"FIA-ISDA Cleared Derivatives Addendum," in the~~ form jointly published by the ~~Futures Industry Association ("*FIA*")~~FIA and ~~the International Swaps and Derivatives Association, Inc. ("*ISDA*") (the "*Cleared Derivatives Addendum*").~~ISDA.

(d) To the extent that the customer engages the FCM to clear and carry foreign futures ~~contracts~~, the customer authorizes the FCM to do so; agrees to the application of the applicable foreign law and the rules of the applicable clearing organization and the terms of the applicable agreement between the FCM and the applicable foreign futures broker; and agrees to comply with margin and other requirements relating to those foreign futures ~~contracts~~ in accordance with the customer agreement, the instructions of the FCM, the rules of the applicable clearing organization, and

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[39] The FCM's obligation to follow the customer's instructions need not be unconditional. It is common for customer agreements to provide that the FCM may decline to accept customer orders in certain circumstances, such as when doing so would result in a breach of a trading or position limit. The FCM may also be entitled to liquidate the customer contracts in some non-default scenarios.

A customer agreement may not explicitly appoint the FCM as the customer's "futures commission merchant" or agent, but through the authorizations noted above, effectively appoints the FCM as such. *See* RESTATEMENT (THIRD) ~~OF~~OF AGENCY § 1.01 (2006) ("Agency is the fiduciary relationship that arises when one person (a ~~"principal")~~'principal') manifests assent to another person (an ~~"agent")~~'agent') that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act."); *id.* § 1.02 ("An agency relationship arises only when the elements stated in §- 1.01 are present. Whether a relationship is characterized as agency in an agreement between parties or in the context of industry or popular usage is not controlling.").

applicable law (including the law governing the applicable clearing organization and its rules).

(e) With respect to any foreign futures ~~contracts~~, the rules of the relevant clearing organization specify that the law of a foreign jurisdiction with which the relevant clearing organization has a material relationship governs the interpretation of such rules (and of the relationship between the clearing organization, the relevant clearing broker and, if applicable, the customer).

(f) ~~Any portfolio margining is conducted in accordance and compliance with SEC and CFTC rules, guidance or interpretation and the rule of the relevant clearinghouses, and~~If the customer clears Portfolio-Margined SNCDS under the customer agreement, the customer agreement or other customer documentation contains the customer disclosures required pursuant to the 2021 SEC Exemptive Order ~~dated December 14, 2012~~.

(g) The customer is required to pay (by way of indemnity, as reimbursement to the FCM or otherwise) all fees, charges and commissions relating to cleared positions held for the customer's ~~customer~~ account, any trading loss, debit balance or deficiency in the customer account (including any interest), and any other costs incurred by the FCM in carrying out its duties pursuant to the customer agreement.

(h) The customer grants to the FCM a security interest in the customer account and all customer transactions, funds and other property held by the FCM in the customer account.

(i) The FCM is authorized, upon the occurrence of a default relating to the customer (including the customer's failure to make any payments owed by the customer to the FCM or the insolvency of the customer), to (i) close out, liquidate or otherwise terminate any customer transactions carried for the customer account, and to debit any realized trading losses and other costs from and credit any realized trading gains to the cash balance of the customer account, (ii) liquidate any remaining non-cash margin or other assets held by the FCM and credit the proceeds to the cash balance of the customer account, (iii) to the extent there is any resulting debit balance or deficiency in the customer account, seek payment thereof by the customer or its estate, and (iv) to the extent there is any resulting credit balance in the customer account, pay the balance over to the customer or its estate or apply the balance to other obligations of the customer, as the case may be.

(j) To the extent that the FCM executes and carries customer ~~accounts~~transactions falling within more than one account class ~~(*i.e.*, futures contracts, cleared swap contracts, foreign futures contracts, and SNCDS within a portfolio margining arrangement)~~ and the parties wish to set up an arrangement whereby the aforementioned accounts can be offset against each other, the customer agreement authorizes the FCM to apply any excess remaining after liquidation of one such account class to any deficit remaining after liquidation of any other such account class.[40]

(k) There is no term providing that, in taking any of the actions referred to in paragraph (j) (including closing out, liquidating or terminating the customer transactions), the FCM is taking these actions as the customer's agent or on the customer's behalf.

(l) There are no provisions overriding or negating the existence of an agency relationship or rights or duties of the FCM, as agent, described in this memorandum.

16. With respect to the uncleared swaps agreement:

(a) Any margin or collateral in the form of securities will consist of securities credited to a securities account of the uncleared swaps affiliate maintained with a third party that is acting as a "securities intermediary" within the meaning of the New York Uniform Commercial Code (the "*UCC*~~"~~)") for the uncleared swaps affiliate.

(b) Any margin or collateral in the form of cash is credited to a "deposit account" maintained by a bank for the uncleared swaps affiliate.

17. Except as otherwise discussed, when the FCM exercises its rights to liquidate customer transactions, foreclose on any collateral, apply customer property to expenses relating to the customer transactions, set off debts or net customer assets and liabilities, it does so in good faith and for proper reasons within the contemplation of the customer agreement.

18. The customer agreement, uncleared swaps agreement, cross-affiliate agreement and other agreements discussed in this memorandum have not been varied, waived or discharged in any material respect in respect of any defaults specified therein, close-out, netting, setoff and other rights and remedies, the scope and nature of any security interest granted or delivery

[40] There may not be an explicit provision in the customer agreement that provides for the ability to offset account classes against one another, but a customer agreement typically would provide the FCM with general authority to set off all amounts payable to or by the Customer with respect to all ~~contracts~~transactions between the FCM and the customer upon close-out.

mechanics for collateral. There are no agreements or understandings between the customer, FCM, uncleared swaps affiliate or any other party that would modify or otherwise affect the terms of the foregoing, or the respective rights or obligations of the parties thereunder in a manner that would prejudice the FCM's or uncleared swaps affiliate's ability to exercise the rights and remedies analyzed in this opinion.

19. No customer agreement or uncleared swaps agreement includes a "walk-away" clause (*i.e.,* a provision under which the non-defaulting party is not required to pay any net or settlement amount due to the defaulting party upon termination) as defined in 12 U.S.C. § 1821(e)(8)(G)(iii).

20. All customer transactions are in compliance with applicable law, including but not limited to requirements for the permissibility of uncleared swaps.

We do not express any opinion as to:

1. The compliance by any person with any law or regulation other than as explicitly set forth in this memorandum, or the effect that failure to comply with any law or regulation may have on the rights or obligations of an FCM, uncleared swaps affiliate, or any other person, including but not limited to any such matters arising under (i) U.S. federal or state commodities, securities, Blue Sky, banking or other laws, rules or regulations, including laws, rules and regulations relating to the capital adequacy of any person, (ii) the rules and regulations of any self-regulatory organization, exchange or clearing organization of which an FCM may be a member, (iii) U.S. federal or state tax laws, rules or regulations, (iv) the Employee Retirement Income Security Act of 1974 or similar laws, (v) laws applicable to individuals, including but not limited to those related to capacity, competency, marriage, divorce or death, or (vi) any laws, regulations or insolvency proceedings other than those of the State of New York (including federal law).

2. Any bankruptcy, insolvency or insurance matters other than those expressly addressed herein.

Moreover, we note that conclusions regarding bankruptcy and insolvency law matters unavoidably have inherent limitations that generally do not exist in respect of other issues on which advice to third parties is typically given. These inherent limitations exist primarily because of the pervasive equity powers of bankruptcy courts, the deference granted to regulatory agencies in resolving failed financial institutions, the overriding goal of reorganization and systemic risk mitigation to which other legal rights and policies may be subordinated, the potential relevance to the exercise of judicial discretion of future arising facts and circumstances, and the nature of the bankruptcy or insolvency process. The reader of this memorandum should take these limitations into

account in analyzing the bankruptcy and insolvency risks associated with the transactions described herein.

~~V. CUSTOMER AGREEMENT, EXECUTION AGREEMENT AND CLEARED DERIVATIVES ADDENDUM~~

~~An FCM is a broker that, among other things, clears transactions through a DCO on behalf of its customers. The FCM, as a member of the DCO and the entity directly facing the DCO on each transaction, agrees in its agreement with the DCO to abide by certain terms and the rules of the DCO. The FCM in turn requires each customer to enter into a customer agreement before establishing accounts and clearing transactions on behalf of that customer. Each FCM has its own default "in-house" customer agreement (there is no standard form across the industry), though each customer agreement will include provisions authorizing the FCM to clear transactions on behalf of the customer and addressing certain principal rights and obligations of the customer, including the customer's obligation to satisfy all margin requirements and other payment obligations and comply with applicable position limits and exchange and DCO rules. In addition, the customer agreement typically includes a grant by the customer of a security interest in, lien on and right of setoff in respect of the customer account and the customer transactions, funds, securities and other property carried therein, certain provisions providing protections to the FCM, including limitations on liability, events of default and remedies, among others, and provisions for the optional termination of the customer agreement by the FCM or transfer of customer transactions by the customer. As described in more detail in Sections VI and VII below, an end customer may not always have a direct relationship with an FCM, as a customer may transact through another broker that in turn transacts with an FCM to execute transactions. In such a case, the parties often enter into a "give up" agreement (a "*Futures Execution Agreement*"), pursuant to which the executing broker confirms that it will "give up" all executed trades to the FCM as the clearing broker that transacts with the DCO. The FIA has developed an industry standard Futures Execution Agreement.[41] The Futures Execution Agreement may also determine the fees that will be required to each of the broker and the FCM.~~

~~Title VII of Dodd-Frank requires standardized swaps designated by the CFTC (which currently includes most IRS and index credit default swaps ("CDS")) to be cleared through a registered DCO and not maintained on a bilateral basis, subject to certain exemptions.[42] As a result, a customer wishing to enter into cleared swap contracts must either be a member of a DCO itself or clear through an FCM.[43] In order for a customer to clear its transactions through a DCO, the customer must enter into a~~

~~[41] *2017 Standard Give-Up Agreements*, FUTURES INDUS. ASS'N, *available at* https://www.fiadocumentation.org/fia/pages/new-standard-give-up-agreements.~~

~~[42] *See* Section VIII *infra* for a discussion of the CFTC's authority to mandate swaps clearing pursuant to Dodd-Frank Section 723 and CEA Section 2(h), and its subsequent mandate with respect to IRS and CDS.~~

~~[43] Swaps may be designated by the CFTC as being subject to the clearing requirements. If so, they likely will also be required to be executed on a SEF. However, the two requirements are separate.~~

customer agreement with an FCM that in turn is a clearing member of the DCO, just as it would for futures contract transactions. For reasons of efficiency, FCMs typically use the same customer agreements to cover cleared swap contracts as they do for cleared futures transactions. However, swaps differ from futures transactions in certain key respects (*i.e.*, margin calculations, requirements and permitted collateral) such that additional documentation is needed in order to properly address swap transactions. In order to standardize the market's approach, FIA and ISDA developed the Cleared Derivatives Addendum to supplement the customer agreement to document the relationship between a clearing member and its customer for purposes of clearing over the counter ("*OTC*") derivatives transactions.[44]

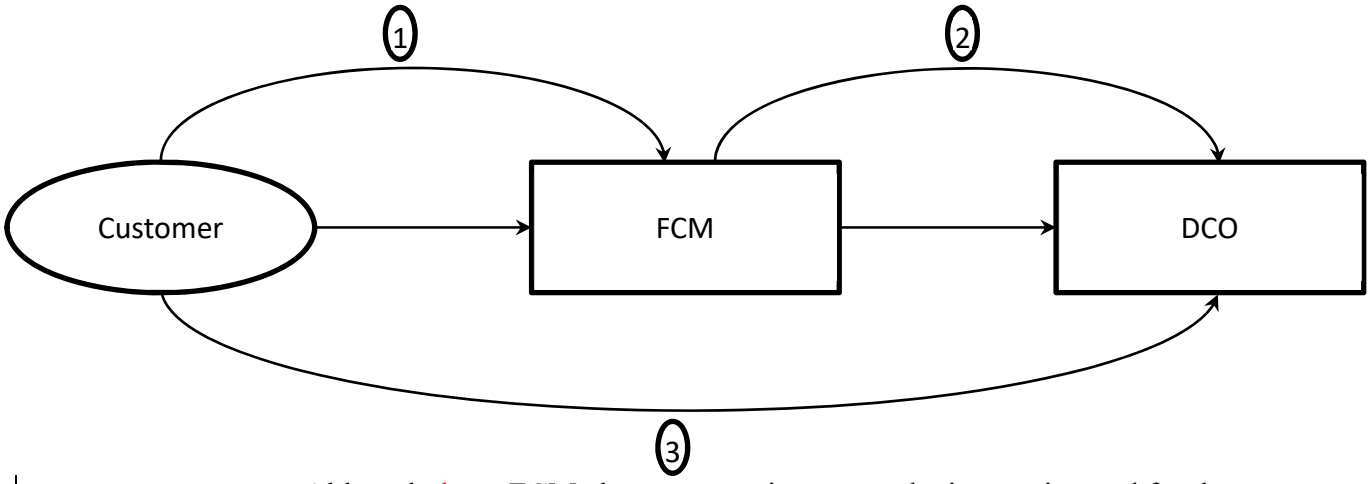
The Cleared Derivatives Addendum includes representations regarding certain clearing-related matters, such as the treatment of customer collateral and representations for both the customer and the FCM with respect to swaps clearing matters.[45] The Cleared Derivatives Addendum also details close-out methodology for cleared OTC swaps, liquidation triggers,[46] and provisions for valuing the terminated trades and tax issues, as described in more detail below. Although structured as a separate Addendum, the Cleared Derivatives Addendum is considered part of the FCM customer agreement and the agreement and Cleared Derivatives Addendum, taken together, constitute a single agreement.

[44] In 2018, FIA and ISDA published an Alternative FIA-ISDA Cleared Derivatives Addendum, which is an optional template that provides an alternative to the Cleared Derivatives Addendum (but does not replace or supersede it).

[45] *See Form of Addendum, Cleared Derivatives Transactions*, FUTURES INDUS. ASS'N & INT'L SWAPS AND DERIVATIVES ASS'N § 2, *available at* https://www.fia.org/sites/default/files/2019-05/FORM%20OF%20ADDENDUM%20CLEARED%20DERIVATIVES%20TRANSACTIONS%208085.pdf.

[46] *See Form of Addendum, Cleared Derivatives Transactions*, FUTURES INDUS. ASS'N & INT'L SWAPS AND DERIVATIVES ASS'N, § 7, *available at* https://www.fia.org/sites/default/files/2019-05/FORM%20OF%20ADDENDUM%20CLEARED%20DERIVATIVES%20TRANSACTIONS%208085.pdf.

VI. STRUCTURE OF THE RELATIONSHIP ~~AMONG~~AMONG PARTIES IN U.S. FUTURES ~~CONTRACTS~~ AND CLEARED ~~SWAP CONTRACTS~~SWAPS



Although ~~the~~an FCM clears transactions upon the instruction and for the risk and benefit of the customer, the FCM's relationship with the DCO in relation to transactions is treated by the DCO as a principal-to-principal relationship and is governed by the terms of the DCO's rules and procedures, to which the customer is not a party. The customer is not in privity of contract with the DCO, the DCO has no liability to the customer and the customer has no rights or claims against the DCO. The FCM is fully liable as principal for all amounts owing to the DCO in connection with the FCM's customer transactions. Such transactions are credited to the FCM's omnibus customer positions account at the DCO maintained in the name of the FCM for the benefit of its customers in the relevant CFTC customer account class (*i.e.*, U.S. futures ~~contracts~~ and cleared ~~swap contracts~~swaps, separately) and, in the case of cleared ~~swap contracts~~swaps, further credited to a sub-account for the customer within such omnibus customer positions account.

~~For every transaction, there are therefore two relevant accounts: (i) the customer's account in the FCM's books in the name of the customer to which all its transactions cleared by that FCM across all DCOs are credited and (ii) an omnibus customer positions account of the FCM at the applicable DCO to which the FCM's customer transactions for all its customers in the relevant CFTC customer account class at that DCO are credited.~~

The relationship between an FCM and its customer in the United States futures markets is described as an "agency" relationship,[47] and this concept has been

[47] *See, e.g.*, 17 C.F.R. § 1.3 (2020) (customer "means any person who uses a futures commission merchant . . . *as an agent* in connection with trading in any commodity interest~~");~~") (emphasis added); *see also Comex Clearing Ass'n, Inc.* v. *Flo-Arb Partners*, 711 F. Supp. 1169, 1173 (S.D.N.Y. 1989) (referring to the FCM as the "clearing agent" for its customers).

applied to the cleared swaps markets as well.[48] However, the agency relationship between the FCM and its customer represents a variant of agency that differs from the more common types of agency arrangements currently in use.[49] Under this variant, the FCM carries out its duties, as agent, for a customer that wishes ~~to trade in~~ the ~~futures markets by executing cleared customer~~ FCM to clear transactions~~, as principal, upon~~ for the ~~customer's instructions, and by clearing~~customer by novating the ~~cleared customer~~ transactions, as principal, with the DCO. When it clears those customer transactions, it does so as the customer's agent and for the customer's account, but~~, as noted, the FCM~~ is the sole contractual counterparty to the DCO under each cleared customer transaction cleared for its customer through the DCO~~; the~~. The customer ~~and the DCO are~~is not in contractual privity with the DCO, either directly or indirectly through the FCM.[50] ~~The~~However, the customer is~~, however,~~ the beneficial owner of the transactions credited to the FCM's omnibus customer position account, entitled to the benefit and subject to the burden of ~~the~~such transactions. ~~In other words, these transactions are held in a type of~~

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48 *See, e.g.*, 17 C.F.R. § 39.12(b)(6)(ii) (2016) ("A derivatives clearing organization that clears swaps shall have rules providing that, upon acceptance of a swap by the derivatives clearing organization for clearing .~~.~~ . . [t]he original swap is replaced by an equal and opposite swap between the derivatives clearing organization and each clearing member acting as principal for a house trade *or acting as agent for a customer trade*~~.")~~.") (emphasis added).

49 For ~~a detailed~~further analysis of the historical and legal foundations of the FCM-customer agency clearing relationship, please see our Memorandum to International Swaps and Derivatives Association, Inc. & Futures Industry Association, dated November 21, 2018, re: Analysis of the Relationships Among Customers, FCMs and DCOs Under the U.S. Agency Clearing Model. To the extent the conclusions in that memorandum differ from those contained in this memorandum, this memorandum supersedes the conclusions contained in that prior memorandum.

50 Although the customer is not a party to the customer transactions cleared by the FCM on the customer's behalf and has no direct obligations to the DCO, the customer is the party that has the economic burden of making good on the amounts due to the DCO under the contract, because the customer agreement requires the customer to pay those amounts to the FCM. Accordingly, even though the FCM is legally obligated to honor the obligations it takes on as principal, it is~~,~~ a credit intermediary – in practical effect, the functional equivalent of a guarantor of the performance by the customer to the DCO because it only enters trades for which the customer is responsible to it. On the other side of the transaction, because the FCM only passes through to the customer amounts actually paid to it by the DCO and does not guarantee the DCO's performance, the customer, and not the FCM, bears the risk of default by the DCO on the customer transactions that the FCM has cleared for the customer. As a result, the FCM, as agent for the customer with respect to the customer transactions that it clears for the customer, takes the customer's credit risk but has no exposure to the DCO with respect to such customer transactions. *See* Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule, 78 Fed. Reg. 62,017, 62,098 (Oct. 11, 2013) (to be codified at 12 C.F.R. pt. 3, 5, 6, 165, 167, 208, 217, 225) ("In regards to the agency clearing model, the agencies note that a clearing member banking organization that acts as an agent for a client and that guarantees the client's performance to the [qualifying central counterparty] would have no exposure to the [qualifying central counterparty] to risk weight. The exposure arising from the guarantee would be treated as an OTC derivative with a reduced holding period, as discussed below.").

~~trust for each customer by the FCM.~~ Each customer will have a beneficial interest in its *pro rata* portion of the net equity arising from the transactions ~~carried by~~om the ~~FCM in its~~FCM's omnibus customer positions account, based on the transactions executed for ~~such customer's~~the account of such customer,[51] but will not have an interest in any specific transaction.

~~In addition to establishing these clearing responsibilities, the customer agreement establishes other related obligations between an FCM and its customer. The FCM is required to establish an account for the customer on its books to which the FCM credits all funds and other property received from the customer as margin or otherwise in connection with trading in cleared customer transactions, and any proceeds received in respect of the cleared customer transactions or other property held for the customer. The customer agreement specifies the fees, expenses or other obligations for which the customer is responsible, and authorizes the FCM to deduct them from the customer's account. The customer agreement also establishes the rights and remedies of the FCM in the event of a customer's default.~~

Like other contractual and agency relationships ~~and relationships of agency~~, the framework for the FCM-customer relationship is established by the applicable agreement (express or implied)[52] between the FCM and its customer governing the relationship and the transactions.[53] However, this agreement must be interpreted under common law and equity (including the law governing agents and principals and the law merchant), in view of the customs and practices of futures commission merchants regulated under the CEA[~~54~~] and the rules and procedures of the applicable clearing organizations.[55] Of particular importance, the CEA itself and the

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[51] *See infra* Section ~~XI~~XI and note 370 (discussing the definition of "net liquidating equity").

[52] *See* RESTATEMENT (THIRD) OF AGENCY § 8.07 (2006) ("An agent has a duty to act in accordance with the express and implied terms of any contract between the agent and the principal.").

[53] Agency arrangements can be formed in a number of ways, potentially even without a binding contract. *See id.* § 3.01 cmt. b ("Actual authority may exist although there is no contract between a principal and agent; a relationship of agency does not require that the principal or the agent receive consideration from the other."). What is required is "a principal's manifestation to an agent that, as reasonably understood by the agent, expresses the principal's assent that the agent take action on the principal's behalf." *Id.* at § 3.01.

[~~54~~] ~~*See, e.g.*, *id.* § 8.07 cmt. b ("A contract may create duties of performance on the part of an agent through its express and implied terms. The terms of an agreement between a principal and an agent may incorporate, either expressly or impliedly, the custom or usage of a particular trade. For example, agreements between securities brokers and their customers may impliedly incorporate the rules and customs of stock exchanges on which brokers execute trades on behalf of their customers. Other terms may be implied as well, for example a requirement that an agent exercise best efforts.").~~

[55] ~~*See also*~~ *See, e.g., id.* § 8.07 cmt. b ("The terms of an agreement between a principal and an agent may incorporate, either expressly or impliedly, the custom or usage of a particular trade. For example, agreements between securities brokers and their customers may impliedly incorporate the rules and customs of stock exchanges on which brokers execute trades on behalf of their customers."); *Richards* v. *New York Mercantile Exch.*, [1980–1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,384 (Sup. Ct. N.Y. Feb. 19, 1982) [hereinafter *Richards*] ("Generally, ~~and~~

related regulations of the CFTC include provisions that establish key elements of the FCM-customer relationship.[56]

A. The Law of Agency

Although the form of customer agreement may vary from FCM to FCM and customer to customer, we assume (as noted in Section ~~IV~~ V above) that each customer agreement contains a provision that authorizes the FCM to execute, clear and carry U.S. futures ~~contracts~~ and/or cleared ~~swap contracts~~swaps on behalf of that customer.[57] The obligations of the FCM, as the customer's agent under the customer agreement, are grounded in the common law of agency.

The common law establishes a framework of rights and obligations applicable to agents and their principals, including agents who transact on behalf of their principals in the manner described above. The framework establishes the agent's duty of

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~~nothing in this case exempts it from the general rule,~~. . . where a customer engages a broker to execute an order on a commodity or stock exchange, the customer is presumed to have contracted with reference to the rules and established customs of the exchange on which the broker deals and to have authorized the broker to conduct the transaction according to such rules and established customs, even though the customer does not have actual knowledge of the rules and customs or is not fully informed in respect thereto."), *aff'd mem.*, 94 A.D.2d 688 (1st Dep't 1983), *motion for leave to appeal denied*, 61 N.Y.2d 604 (1984); *see also Moss* v. *J.C. Bradford & Co.*, 337 N.C. 315, 324 (1994) ("The rules of the various exchanges, promulgated as they are with express Congressional authorization and, in most cases, having been approved by the CFTC, possess the force of law .~~. .~~ . . . They are therefore binding on all who trade on such exchanges, both merchants and their customers .~~. .~~ . . . Indeed, 'Congress primarily has relied upon the exchanges to regulate the contract markets.'") (citations omitted).

Some customer agreements include integration clauses, providing that the express terms of the contract supersede past practices and other extra-contractual sources. However, if the contract also refers to custom and practice or other such sources, an integration clause should not preclude the interpretation of the contract in light of the referenced sources. *See Bonnell/Tredegar Indus., Inc.* v. *NLRB*, 46 F.3d 339, 347 (4th Cir. 1995) (finding integration clause not applicable where past practice was implicitly incorporated by express terms of contract).

56 *See First Am. Disc. Corp.* v. *Jacobs*, 324 Ill. App. 3d 997, 1007-08 (Ill. App. Ct. 2001) (finding that, "under the federal regulatory scheme," FCM ~~is~~ permitted ~~by contract terms and by law~~ to liquidate ~~an~~ under-margined customer account without notice, and that liquidation without notice would be allowed by law "even if the contract with the customer required a prior margin call"); *Moss* v. *J.C. Bradford & Co.*, 337 N.C. 315, 328 (1994) ("[A]ny terms contrary to the federal regulatory scheme in the area of futures trading would be unenforceable."); *see also* RESTATEMENT (THIRD) OF AGENCY § 8.07 cmt. b (2006) ("Statutes and administrative regulations may prescribe or otherwise regulate the terms of contracts between particular types of principals and agents~~. For example, federal regulation applicable to customs brokers prohibits contractual limits on their liability when engaging in the customs business.")~~.").

57 As noted above, we define "customer agreements" to include agreements related to futures contracts, cleared ~~swap contracts~~swaps and foreign futures contracts.~~-~~ However, a customer could enter into an agreement with an FCM to clear just one or two such types of transactions.

loyalty to its principal,[58] which includes a prohibition on the use of the property of the principal for the agent's own purposes or those of a third party;[59] to comply with the terms of any contract between the agent and the principal;[60] to act with care, competence and diligence;[61] to act only within the scope of the agent's authority and to comply with the principal's instructions;[62] to provide information to the principal;[63] and to segregate the principal's property from that of any other person and keep and render accounts to the principal of money and property received or paid out on the principal's account.[64] At the same time, the principal has the duty to comply with the terms of any contract between the agent and the principal;[65] to indemnify the agent in accordance with any contract and, unless otherwise agreed, for any payment made by the agent on the principal's behalf or any loss suffered by the agent that "fairly should be borne by the principal in light of their relationship";[66] and to deal fairly and in good faith with the agent.[67] ~~The~~However, the common law ~~also~~ permits the agent and its principal to vary these rights and obligations within the limits of good faith, full disclosure and fair dealing.[68] In the case of the FCM-customer relationship, these duties have, in fact, been varied by the usage and customs of the futures industry, the terms of customer agreements and the historical practices on which both are based and, perhaps most importantly, by the CEA and the related rules of the CFTC~~, as discussed below~~.

~~Although grounded in common-law principles of agency, the nature of the agency relationship between an FCM and its customer differs in some key respects from~~

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58 RESTATEMENT (THIRD) OF AGENCY § 8.01 (2006) ("An agent has a fiduciary duty to act loyally for the principal's benefit in all matters connected with the agency relationship.").

59 *Id.* § 8.05.

60 *Id.* § 8.07.

61 *Id.* § 8.08.

62 *Id.* § 8.09.

63 *Id.* § 8.11.

64 *Id.* § 8.12.

65 *Id.* § 8.13.

66 *Id.* § 8.14.

67 *Id.* § 8.15.

68 *See id.* § 8.06 ("(1) Conduct by an agent that would otherwise constitute a breach of duty as stated in §§ 8.01, 8.02, 8.03, 8.04, and 8.05 does not constitute a breach of duty if the principal consents to the conduct, provided that (a) in obtaining the principal's consent, the agent (i) acts in good faith, (ii) discloses all material facts that the agent knows, has reason to know, or should know would reasonably affect the principal's judgment unless the principal has manifested that such facts are already known by the principal or that the principal does not wish to know them, and (iii) otherwise deals fairly with the principal; and (b) the principal's consent concerns either a specific act or transaction, or acts or transactions of a specified type that could reasonably be expected to occur in the ordinary course of the agency relationship."). ~~While~~Although the Restatement Second did not have a counterpart to § 8.06 ("Principal's Consent"), in relevant part "[the Restatement Second's] sections articulating an agent's duties of loyalty are prefaced by '[u]nless otherwise agreed.'" *Id.* § 8.06 note a.

~~most agency relationships. In 1976, CFTC Chairman William Bagley described the FCM-customer relationship as follows:~~

The common law also establishes default rules relating to the relationships among the agent, the principal, and third parties with whom the agent deals on the principal's behalf. When an agent makes a contract with a third party on behalf of a disclosed principal, the default rule is that the principal and the third party are the parties to the contract, and the agent is not a party, unless the agent and the third party otherwise agree.[69] When an agent acting with actual or apparent authority makes a contract on behalf of an "unidentified principal" – *i.e.,* the third party knows that the agent is acting for another party but does not know the identity of that party –the principal and the third party are parties to the contract, and the agent is also a party to the contract unless the agent and the third party agree otherwise.[70] In the context of clearing U.S. futures and cleared swaps, the customer, the FCM and the principal have agreed otherwise, pursuant to the customer agreement and the practices, laws and DCO rules that it incorporates.

As CFTC Chairman William Bagley noted in 1976:

> As will be discussed later, while the clearing house recognizes the rights of commodity customers, it deals only with its clearing members. The actual contractual situation is much more complex. The clearing house is contractually bound to its clearing members, not the customers on whose behalf clearing members present trades for clearing. The clearing member, not the clearing house, is contractually bound to the customers.[71]

Similarly, the court in *Leist* describes the relationship between an FCM and a ~~clearing-house~~clearinghouse as follows:[72]~~:~~

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69 *Id.* § 6.01, § 6.01 cmt. b (2006) ("A principal who deals with third parties through an agent ordinarily expects to become a party to transactions entered into on the principal's behalf by the agent. When the third party knows the identity of the principal, the third party ordinarily expects that the principal, and not the agent, will become a party to the transaction."). Because the DCO is notified of the identity of a customer for whom it clears a cleared swap, this default rule would appear to have been applicable to cleared swaps, barring the modifications to the default rule discussed below.

70 *Id.* § 6.02. Because the DCO is notified that the FCM is clearing for a customer when it clears U.S. futures, this default rule would appear to have been applicable to U.S. futures, barring the modifications to the default rule discussed below.

71 *Bankruptcy Act Revision: Hearings on H.R. 31 and H.R. 32 Before the Subcomm. on Civil & Constitutional Rights of the H. Comm. on the Judiciary*, 94th Cong. 2380 n.8 (1976). The provisions being discussed at these sessions were later adopted as Subchapter IV of Chapter 7 of the Bankruptcy Code.

72 *Leist* v. *Simplot*, 638 F.2d 283, 287 (2d Cir. 1980), *aff'd sub nom. Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Curran*, 456 U.S. 353 (1982).

> The clearinghouse treats FCM's as principals in trading transactions and demands margin payments from them. The clearinghouse requires FCM's to "mark to the market" at the close of every trading day. Any net gain or loss which the FCM has sustained in the course of the day's trading is computed and margin adjustments are made accordingly.[73]

Some courts have referred to an FCM as a "clearing agent" for its futures customers,[74] while acknowledging the contractual relationship between the clearing member FCM and the clearing organization as a principal-to-principal relationship.[75] Other courts have also acknowledged that the obligations under a futures contract are between the clearing member and the clearinghouse, not the customer and the clearinghouse.[76]

In other words, DCOs are contractually bound only to the clearing member, which is posting margin deposits to secure the ~~customer~~ transactions it has ~~entered into~~cleared for its customers, and only the clearing member can satisfy its obligations. ~~DCOs have obligations to customers only as a class (*i.e.*, segregation) but not~~

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[73] *Id.* at 287; *see also Bd. of Trade of City of Chicago* v. *Christie Grain Stock Co.*, 198 U.S. 236, 245 (1905) ("In these pits the members make sales and purchases exclusively for future delivery, the members dealing always as principals between themselves, and being bound practically, at least, as principals to those who employ them when they are not acting on their own behalf.").

[74] *See, e.g.*, *Peltz* v. *SHB Commodities, Inc.*, 115 F.3d 1082 (2d Cir. 1997); *Comex Clearing Ass'n, Inc.* v. *Flo-Arb Partners*, 711 F. Supp. 1169 (S.D.N.Y. 1989).

[75] *See, e.g.*, *Comex Clearing*, 711 F. Supp. at 1175 (referring to FCM clearing members as "clearing agents" but also stating that "members of CCA are treated by the association as principals for all transactions, whether acting as principal or for a customer"). Similarly, in the ~~1990's~~1990s, the two largest clearing organizations, the Options Clearing Corporation (a clearing agency regulated by the Securities and Exchange Commission and not a DCO) and the Chicago Mercantile Exchange Clearing Division (a futures clearing organization regulated by the CFTC) had a "Principal to Principal contractual relationship" with their clearing members. *See* IAN W. T. MCGAW, THE WORLD'S CLEARING HOUSES: A COMPREHENSIVE REPORT AND ANALYSIS OF CLEARING FOR EXCHANGE TRADED FUTURES AND OPTIONS (1993). ~~That is, "while segregating a Clearing Member's House and Client accounts, the Chicago Mercantile Exchange ("*CME*") has no responsibility for settlements between a Clearing Member and his clients" and "Clearing Members are fully responsible for performance irrespective of the situation of their clients." *Id.*~~

[76] *See, e.g.*, *In re Griffin Trading Co.*, 245 B.R. 291, 296 (Bankr. N.D. Ill. 2000), *vacated*, 270 B.R. 882 (Bankr. N.D. Ill 2001) ("If the customer has made money, the clearing house will make a variation margin payment to its member, who will pay the submitting broker, who will pay the customer's account. If the customer has lost money, the clearing house will demand payment of the loss from the clearing member, who will demand payment from the submitting broker, who will debit the customer's account for the loss or demand payment from the customer if the assets in the customer's account are insufficient to cover the loss."); *see also Bernstein* v. *Lind-Waldock & Co.*, 738 F.2d 179, 181 (7th Cir. 1984) ("When a nonclearing floor trader, such as Caan, sells a futures contract to a third party, the contract of sale is actually between the floor trader's clearing member, here Lind-Waldock, and the buyer's clearing member."); *Leist* v. *Simplot*, 638 F.2d 283 (2d Cir. 1980), *aff'd sub nom. Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Curran*, 456 U.S. 353 (1982) ("The clearinghouse treats FCM's [sic] as principals in trading transactions and demands margin payments from them.").

~~to any individual customers.~~ As Bagley noted, the clearing member's customer is not able to make the required margin deposit to keep the customer's trades open: only the clearing member can.[77] DCOs have obligations to customers as a class (*i.e.*, segregation requirements) but not to any individual customer.[78]

CFTC staff reiterated this view in 1985 when examining the rights of a clearinghouse with respect to customer funds delivered to the clearinghouse by an FCM, saying, "clearing organizations' direct customers are, generally, clearing firms, not the ultimate 'customers' who entered into the futures contracts and options positions accepted for clearance by the clearing organization .~~. .~~ . . . The clearing organization normally has no direct dealings with such customers and has knowledge neither of their specific identities nor of the extent of their respective ownership interests in margin funds posted by its clearing firms."[79] The rules of DCOs ~~clearing customer~~relating to transactions cleared for customers reflect this arrangement.[80]

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77 "It is the clearing member who is called upon to make the margin deposits to secure the contracts of its customers, and it is only the clearing member who can make the required deposit and thereby keep his customers' trades open; his customers cannot." *Bankruptcy Act Revision: Hearings on H.R. 31 and H.R. 32 Before the Subcomm. on Civil & Constitutional Rights of the H. Comm. on the Judiciary*, 94th Cong. 2380 n.8 (1976). As discussed below, the amendments that were adopted defined the "customer" of the clearinghouse as the *member* of the clearinghouse ~~—~~ – not the member's customer~~—~~ – reflecting the fact that only the member deals directly with the clearinghouse. 11 U.S.C. § 761(9)(D).

78 *See* Ian W. T. McGaw, *supra* note 67. That is, "while segregating a Clearing Member's House and Client accounts, the Chicago Mercantile Exchange ("CME") has no responsibility for settlements between a Clearing Member and his clients" and "Clearing Members are fully responsible for performance irrespective of the situation of their clients." *Id.*

79 Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies, 75 Fed. Reg. 75,162, app. at 75,166 (Dec. 2, 2010) (to be codified at 17 C.F.R. pt. 190); Brief for the United States as Amicus Curiae Supporting Petitioner at 12, *Klein & Co. Futures Inc.* v. *Bd. of Trade of the City of New York*, 550 U.S. 956 (2007) (No. 06-1265), 2007 U.S. S. Ct. Briefs LEXIS 451 at *11 ("Even when clearing FCMs enter into futures contracts on behalf of their customers rather than on their own accounts, '[c]learinghouses look to the funds and credit of clearing FCMs for satisfaction of trading obligations rather than to the actual floor broker, floor trader, or other customer.' .~~.~~ . . That is a long-established feature of the commodity futures trading industry. As the CFTC explained more than 20 years ago, 'clearing organizations generally have as their direct customers FCMs, not the ultimate 'customers' who entered into the futures contracts and options positions for which the [FCM's] margin funds were posted.' 50 Fed. Reg. 36,050 (1985); *see Leist*, 638 F.2d at 287 ('The clearinghouse treats FCM's [sic] as principals in trading transactions.'); CFTC Interpretative Statement No. 85-3, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) P 22,703, at 30,987 (Off. Gen. Counsel Aug. 12, 1985).").

80 *See* ICE Clear U.S., Inc., Rule 401(a) (explaining that the clearinghouse, "by accepting a Contract offered to it for clearance by or on behalf of a Clearing Member, shall assume, in the place of each Clearing Member that is a party to such Contract, all liabilities and obligations imposed thereby to the Clearing Member that is the other party thereto"); ICE Clear U.S., Inc., Rule 401(b)(i) (explaining that the liabilities and obligations of the clearinghouse "shall extend only to clearing members," and that the clearinghouse "shall not have any liability or obligation arising out of or with respect to any contract to any customer of a clearing member"). ICE Futures U.S., Inc., Rule 4.10(b) (all trades must be submitted for clearing); ICE Clear U.S., Inc., Rule 504(a) (describing

As noted above, this agency model differs from the more common types of agency in use today. ~~In general, when an agent executes a contract with a third party on behalf of a disclosed principal, it is expected that the principal — not the agent — will be the party bound by the contract.[81] An unidentified principal (*i.e.*, a principal who is known to exist but whose identity is not known) is also generally liable with respect to a contract executed by an agent on the principal's behalf.[82]~~ However, an agent may agree with a third party that the *agent* is liable for its principal's performance, and the agent and the third party may also agree as to whether the principal itself is a party to, and directly liable to the third party under, the contract at all~~, particularly when the agent is acting on behalf of more than one principal~~.[83] It is the agent and third party's agreement that determines whether the principal and third party are in privity. "If an agent . ~~—~~ . . makes an authorized contract with a third person, the liability of the principal thereon depends upon the agreement between the agent and the ~~other party~~third person as to the parties to the transaction."[84] Thus, "[t]here may be an agreement that the principal alone is a party, that the agent alone is a party, or that the principal and the agent are both to be parties."[85]

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payment obligations between the clearinghouse and its clearing members resulting from each day's trading gains and losses).

~~[81] RESTATEMENT (THIRD) OF AGENCY § 6.01 cmt. b (2006) ("A principal who deals with third parties through an agent ordinarily expects to become a party to transactions entered into on the principal's behalf by the agent. When the third party knows the identity of the principal, the third party ordinarily expects that the principal, and not the agent, will become a party to the transaction.").~~

~~[82] *Id.* § 6.02 ("When an agent acting with actual or apparent authority makes a contract on behalf of an unidentified principal, (1) the principal and the third party are parties to the contract; and (2) the agent is a party to the contract unless the agent and the third party agree otherwise.").~~

[83] ~~RESTATEMENT (SECOND) OF AGENCY~~ RESTATEMENT (SECOND) OF AGENCY §§ 146; *accord* RESTATEMENT (THIRD) OF AGENCY §§ 6.01, 6.02 (2006). Even under the typical agency model, the principal may not be liable under a contract executed on its behalf when the agent is acting on behalf of more than one principal. *Id.* § 148 (1958) ("Unless otherwise agreed between the principal and the agent, no one of two or more disclosed or partially disclosed principals, each of whom independently authorizes the same agent to make a contract, is liable upon a single contract made by the agent which combines the orders of the principals and calls for a single performance.").

[84] RESTATEMENT (FIRST) OF AGENCY § 146 (1933); *accord* RESTATEMENT (SECOND) OF AGENCY § 146 (1958) ("If an agent of a disclosed or partially disclosed principal makes an authorized contract with a third person, the liability of the principal thereon depends upon the agreement between the agent and the other party as to the parties to the transaction."); RESTATEMENT (THIRD) OF AGENCY § 6.02 cmt. b ("An unidentified principal becomes a party to a contract made by an agent who acts with actual or apparent authority, *unless the agent and the third party agree that the principal shall not become a party*.") (emphasis added); RESTATEMENT (THIRD) OF AGENCY § 6.01 cmt. b (although the principal and third party ordinarily expect that the principal will become a party to transactions entered into on the principal's behalf by the agent, "[a]n agent and a third party, however, may agree otherwise~~.")~~.").

[85] RESTATEMENT (FIRST) OF AGENCY § 146 cmt. a (1933).

~~The application of this rule to the clearing of futures contracts has been acknowledged.~~[86] DCO rules reflect such an agreement.[87]

Put another way, a "contract made by the agent on account of the principal does not result in a contract between the principal and the third person if the agent and the third person agree that the transaction is only the contract of the agent"[88] and the principal may be "excluded" as a party either by the terms of the contract or otherwise by agreement of the parties.[89] In such case, the agent is a party to the contract with the third party and, as such, is responsible for its performance. Moreover, if the principal is excluded as a party to the contract, it has no claim against the third party and the third party does not become liable to the principal upon the contract in an action at law. The agent, of course, maintains privity with its principal.

If an agent agrees with a third party to exclude the agent's principal from the contract with the third party, the agent holds that contract as an "agent-trustee"[90] for the benefit of its principal:

> If it is agreed that the other party contracts solely with the agent, the principal does not become a party to the transaction; the agent *becomes a trustee holding the contract for the principal's benefit*, and the other party has rights against the principal only through the rights of

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~~[86] *See Richards*, *supra* note 23 ("[T]here was never intended to be nor did there ever arise any direct contractual relationship between The Exchange and [the customer], or any duties or obligations running between them *inter se*. [The customer's], reliance upon principals [sic] of agency is misplaced. The general agency rule that a principal may enforce against a third party, a contract made on his behalf by his agent has no applicability where the terms of the contract specifically exclude [by referencing the applicable exchange's rules] the principal as a party to that contract.").~~

[87] *See supra* note 67; *see also Richards*, *supra* note 47 ("[T]here was never intended to be nor did there ever arise any direct contractual relationship between The Exchange and [the customer], or any duties or obligations running between them *inter se*. [The customer's], reliance upon principals [sic] of agency is misplaced. The general agency rule that a principal may enforce against a third party, a contract made on his behalf by his agent has no applicability where the terms of the contract specifically exclude [by referencing the applicable exchange's rules] the principal as a party to that contract.").

[88] RESTATEMENT (SECOND) OF AGENCY §- 144 cmt. f (1958).

[89] RESTATEMENT (THIRD) OF AGENCY §§ 6.02 cmt. b, 6.03 (2006); *see Richards*, *supra* note ~~23.~~47.

[90] RESTATEMENT (SECOND) OF TRUSTS, Introductory Note to Chapter 1 Topic 2 (1959) ("If [an agent] holds title to property for the benefit of his principal, he is in a sense a trustee; but since his conduct is wholly subject to the control of his principal, he is an agent. Such a person may be called an agent-trustee."). "An agent-trustee is one who holds a title but is also subject to control by the beneficiary." *S.E.C.* v. *Am. Bd. of Trade, Inc*., 654 F. Supp. 361, 366 (S.D.N.Y.), *aff'd*, 830 F.2d 431 (2d Cir. 1987) (citing RESTATEMENT (SECOND) OF AGENCY §- 14B and comments a–c (1977)); *see also* RESTATEMENT (THIRD) OF AGENCY §- 1.04 (2006) ("A trustee is a holder of property who is subject to fiduciary duties to deal with the property for the benefit of charity or for one or more persons, at least one of whom is not the sole trustee. An agent-trustee is a trustee subject to the control of the settlor or of one or more beneficiaries.").

> exoneration which the agent may have against him, or on other restitutional grounds.[91]

The use of the word "trustee" in this context refers to the capacity in which the agent holds title to its principal's property, and does not imply that the agent is a common-law trustee or subject to the law governing common-law trusts.[92] The trust relationship in this context is solely a function of the customer agreement and the rules of the CFTC and relevant clearinghouses, and not trust law more generally. Accordingly, the relationship between an agent-trustee and its principal "is technically one of trust as well as agency but remains subject to the rules applicable to agents rather than to those applicable to trustees."[93] "The mere fact that an agent is entrusted not merely with possession but also with the title to property for his principal does not make applicable the rules which are applicable to trusts, but the rules applicable to agency are applicable."[94] The consequence of the agent holding property as an agent-trustee is that the principal — not the agent — has the beneficial interest in the property held by the agent-trustee, including any transactions entered into on its behalf, and can terminate the agency at any time permitted

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91 RESTATEMENT (SECOND) OF AGENCY § 147 cmt. b (1958) (emphasis added)*; see also* FLOYD R. MECHEM, A TREATISE ON THE LAW OF AGENCY § 2568, at 2164 n.85 (2d ed. 1914).

92 RESTATEMENT (SECOND) OF TRUSTS, Introductory Note to Chapter 1 Topic 2 (1959) ("[I]t may be important to distinguish an agency from a trust. . . . Even if [the agent] is given title to property, he is still subject to the rules applicable to agency rather than those applicable to trusts."); RESTATEMENT (SECOND) OF TRUSTS ("There are a number of widely varying relationships which more or less closely resemble trusts, but which are not trusts, although the term 'trust' is sometimes used loosely to cover such relationships. It is important to differentiate trusts from these other relationships, since many of the rules applicable to trusts are not applicable to them.").

93 RESTATEMENT (THIRD) OF TRUSTS § 5 cmt. f (2003); *see also* RESTATEMENT (SECOND) OF TRUSTS, Introductory Note to Chapter 1 Topic 2 (1959) ("[I]t may be important to distinguish an agency from a trust. ~~Ordinarily, an agent does not acquire title to property of his principal. Even if he~~ . . . Even if [the agent] is given title to property, he is still subject to the rules applicable to agency rather than those applicable to trusts~~. If he holds title to property for the benefit of his principal, he is in a sense a trustee; but since his conduct is wholly subject to the control of his principal, he is an agent. Such a person may be called an agent trustee~~."); RESTATEMENT (SECOND) OF TRUSTS ("There are a number of widely varying relationships which more or less closely resemble trusts, but which are not trusts, although the term 'trust' is sometimes used loosely to cover such relationships. It is important to differentiate trusts from these other relationships, since many of the rules applicable to trusts are not applicable to them."); *Am. Bd. of Trade, Inc.*, 654 F. Supp. at 366 ("The distinction between a trustee and agent lies in the element of control and the extent of disposition of the property. A party who merely has possession of property of another and, although authorized to deal with that property, is subject to control by its owner, is an agent of the owner. A trustee, however, holds legal or equitable title to the property placed in his possession and may or may not be subject to the beneficiary's control. An agent-trustee is one who holds a title but is also subject to control by the beneficiary.").

94 RESTATEMENT (SECOND) OF TRUSTS § 8 cmt. h (1959) (citing RESTATEMENT (SECOND) OF AGENCY, § 14B).

under the applicable agreement.[95] As beneficiary, the principal "has rights in the property which are the normal incident of owning the property."[96]

Thus, in executing, clearing and carrying ~~cleared customer~~ transactions on behalf of its customers, the FCM does so in its own name, but it carries the transactions as agent-trustee for the benefit of the customer, under the terms established by the customer agreement~~.~~ and the incorporated industry practices, DCO rules and other "applicable laws." This is why, while consistently acknowledging that the relationship between a DCO and the FCM is a principal-to-principal relationship, the CFTC's rules also confirm both that the FCM acts as the agent of its customer,[97] and, in the case of swap transactions, that the customer transactions "belong to" the customers.[98] While this language may seem to be in contradiction to the principal-to-principal relationship described in this memorandum, in fact, without referring explicitly to the principles of agency on which the arrangement is based, the CFTC's regulations reflect the role of the FCM as an "agent-trustee" of the customer.

Importantly, although the FCM acts as the customer's agent in respect of the execution, clearing and carrying of ~~cleared customer~~ transactions, the FCM does not act as the customer's agent with respect to all aspects of their relationship.

> Even though a person is termed an agent, he may, in fact, act as such in some matters but not in others." .~~:~~ . . Accordingly, even though one may be an agent for some purposes, if an alleged agent's acts concerning a certain subject matter cannot be controlled and directed by the

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95 *See* RESTATEMENT (SECOND) OF TRUSTS §~ 12 cmt. a (1959); *see also Am. Bd. of Trade, Inc.*, 654 F. Supp. at 366 ("The distinction between a trustee and agent lies in the element of control and the extent of disposition of the property. A party who merely has possession of property of another and, although authorized to deal with that property, is subject to control by its owner, is an agent of the owner. A trustee, however, holds legal or equitable title to the property placed in his possession and may or may not be subject to the beneficiary's control. An agent-trustee is one who holds a title but is also subject to control by the beneficiary.").

96 *Beneficial Owner*, BLACK'S LAW DICTIONARY (6th ed. 1990) ("Beneficial interest. Term applied most commonly to cestui que trust [*i.e.*, the beneficiary of a trust] who enjoys ownership of the trust or estate in equity, but not legal title which remains in trustee or personal representative. Equitable as contrasted with legal owner.").

97 ~~*See* 17 C.F.R. § 39.12(b)(6)(ii) (2016) ("A derivatives clearing organization that clears swaps shall have rules providing that, upon acceptance of a swap by the derivatives clearing organization for clearing: . . . (ii) The original swap is replaced by an equal and opposite swap between the derivatives clearing organization and each clearing member acting as principal for a house trade *or acting as agent for a customer trade*.") (emphasis added).~~ *See supra* notes 40 and 41.

98 With respect to swaps, the CFTC's regulations acknowledge that customer transactions (and the related margin or collateral, as discussed below) should be "treat[ed] and deal[t] with" as "belonging to" the relevant customers. ~~*Id*~~17 C.F.R. § 22.2(a) (2020).

> principal, there is no agency relationship with regard to that subject matter.[99]

In other words, it is possible for a single agreement to provide for both obligations of an agent that are subject to the rights and duties of an agent to its principal, and for other obligations that are simply contractual obligations between the two parties. As discussed in more detail below, that is the case in the context of an FCM-customer relationship.

B. The Impact of Federal Commodities Regulations

The structure of the FCM-customer agency relationship described above is derived from common-law principles of agency, as applied in the futures industry and in the commodities trading businesses from which it developed. However, beginning with the federal regulation of the commodities industry in the 1930s, a legislative and regulatory framework has developed that both modifies the common-law agency relationship and supplies essential elements of the relationship between an FCM and its customer. Most critical, for purposes of this analysis, is the "segregation" framework under which an FCM must handle its ~~customers' funds.~~[100] U.S. futures and cleared swaps customers' money, securities, and other property received from or for the customer in connection with U.S. futures and cleared swaps.

Section 4d(a)(2) of the CEA~~,~~[101] and the related regulations of the CFTC~~,~~ ~~creates~~ create a framework for the treatment of U.S. futures customer funds that requires the segregation of customer funds relating to U.S. futures[102] to protect customers both from misuse of their customer funds by the FCM and from claims by creditors of the FCM, while permitting the FCM to use the customer funds to satisfy obligations undertaken by the FCM when clearing ~~customer contracts~~U.S. futures for its customers.[103] Under Section 4d(a)(2), by ~~agreeing to serve~~acting as a customer's futures

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99 *In re Drexel Burnham Lambert Grp. Inc.*, 113 B.R. 830, 841-42 (Bankr. S.D.N.Y. 1990) (citations omitted).

~~100 "*Customer funds*" means all money, securities, and other property received by an FCM or DCO clearing organization from, for, or on behalf of, its customers to margin, guarantee, or secure cleared customer transactions and all money accruing to such as the result of such contracts, as well as funds received to be used as a premium for the purchase of a commodity option transaction for such customer or constituting the settlement value of a swap in the form of an option. *See* 17 C.F.R § 1.3 (2020).~~

101 7 U.S.C. § 6d(a)(2).

102 As noted above in Section IV.B above, "customer funds" include all money, securities, and other property received by an FCM or DCO clearing organization from, for, or on behalf of, its customers to margin, guarantee, or secure transactions and all money accruing to such as the result of such contracts.

103 *See* Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations, 78 Fed. Reg. 68,505, 68,509 (Nov. 14, 2013) (to be codified at 17 C.F.R. pt. 1, 3, 22, 30, 140) ("The statutory mandate to segregate customer funds—to treat them as belonging to the customer and not use the funds inappropriately—takes on greater meaning in light of the devastating events experienced over the

commission merchant, an FCM becomes subject to a statutorily imposed duty to the customer to treat those customer funds as "belonging to the customer."[104] ~~Similarly, an FCM clearing swaps for a customer must~~Section 4d(f) of the CEA,[105] added by the Dodd-Frank Act, creates a parallel framework for cleared swaps, and the CFTC has enacted parallel rules requiring an FCM to "treat and deal with the Cleared Swaps of Cleared Swap Customers and associated Cleared Swaps Customer Collateral as belonging to Cleared Swaps Customers."[106]

Beginning with the adoption of the CEA in 1936, "futures commission merchants" and their treatment of customer property were subject to direct federal jurisdiction.[107] FCMs were required to register with the Secretary of Agriculture[108] and were required to treat all property received from a customer to margin, guarantee or secure any trades or contracts "as belonging to such customer," to account for such property separately, to segregate customer property from their own property (although property of different customers could be commingled), and to not use any customer's

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last two years. Those events, which are discussed in greater detail below, demonstrate that the risks of misfeasance and malfeasance, and the risks of an FCM failing to maintain sufficient excess funds in segregation: (i) Put customer funds at risk; and (ii) are exacerbated by stresses on the business of the FCM.").

These segregation and bankruptcy protections do not apply to "proprietary accounts," which include any account held by "a business affiliate [of the FCM] that directly or indirectly controls such individual, partnership, corporation or association; or a business affiliate that, directly or indirectly is controlled by or is under common control with, such individual, partnership, corporation or association." 17 C.F.R. §- 1.3 (2020); *see* Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions, 7 Fed. Reg. 6,371 (Feb. 7, 2012). Thus, contracts and property held in these accounts would be addressed in the same manner as those belonging to the FCM itself.

104 7 U.S.C. §- 6d(a)(2).

105 *Id.* § 6d(f).

106 17 C.F.R. § 22.2(a) (2020).

107 "For your information, we offer the following summary of the more important objectives sought by the bill: … 3. To register commission merchants handling funds of the public and floor brokers executing the orders. The registration would be subject to suspension or revocation for cause. 4. To safeguard margins deposited by the public, declaring it to be unlawful for commission merchants to use such funds for their own private operations or to extend credit to others…. 6. To prohibit commission merchants and floor brokers from taking customers' orders into their own account." *To Amend the Grain Futures Act: Hearings on H.R. 6722 before the S. Comm. on Agric. & Forestry*, 74th Cong. 18-22 (1936) (letter from Mr. M. W. Thatcher, the Farmers National Grain Corporation, to Sen. Charles McNary); *see also id*. at 69 (statement of Mr. Weymouth Kirkland, Chicago Board of Trade) ("[The CEA] requires every commission merchant to register and to treat the money or securities received as a margin to secure trades as belonging to the customer, and forbids the use thereof by the commission merchant to margin or guarantee the trades or contracts, or to secure or extend the credit of any other customer or person, with certain exception.").

108 Commodity Exchange Act, Pub. L. No. 74-675, §- 4d(1), 94 Stat. 1491, 1494 (1936) ("It shall be unlawful for any person to engage as futures commission merchant .~~,~~ . . unless (1) such person shall have registered, under this Act, with the Secretary of Agriculture as such futures commission merchant."). The Secretary of Agriculture was responsible for administering the CEA at this time.

property to secure the obligations of any other customer.[109] The CEA permits an FCM to draw upon the customer funds held in segregation to:

> margin, guarantee, secure, transfer, adjust, or settle the contracts or trades of such customers, or resulting market positions, with the clearinghouse organization of such contract market or derivatives transaction execution facility or with any member of such contract market or derivatives transaction execution facility, .~~..~~ . . , including the payment of commissions, brokerage, interest, taxes, storage, and other charges, lawfully accruing in connection with such contracts and trades.[110]

The ~~segregated~~FCM may use customer funds ~~may~~ for these purposes ("*Permitted Uses*"), but not ~~be used~~ for any other purpose, whether or not the customer agrees.

As noted above, the segregation requirement was adopted to curb two types of abuses that resulted from common practices undertaken by futures commission merchants. First, some commission merchants in the futures markets used customer funds, typically belonging to smaller customers, to extend credit to more favored customers, which were typically large speculators, who would then take large market positions that allowed them to influence prices and allegedly manipulate the market against the smaller customers. Second, some commission merchants used customer funds for proprietary trading purposes, which, upon the failure of the commission merchants, were paid to clearing members holding opposite positions in the market rather than to the customers that supplied the funds.[111] Today, in addition to protecting the customer, by preventing the misuse of the customer's customer funds, segregation is also recognized as a key measure protecting the markets, by ensuring the availability of funds to the FCM when required to comply with its obligations to a DCO in respect of the customer's ~~customer~~ transactions.[112]

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109 *Id*. at § 4d(2); *see* 7 U.S.C. §- 6d(a)(2). For a description of the scope and nature of the segregation requirement, *see* JERRY MARKHAM, THE HISTORY OF COMMODITY FUTURES TRADING AND ~~ITS~~ITS REGULATION 60-72 (1986).

110 7 U.S.C. § 6d(a)(2). The corresponding provision for swap transactions permits the FCM to utilize segregated customer funds of a customer to "margin, guarantee, secure, transfer, adjust, or settle a cleared swap with a derivatives clearing organization, or with any member of the derivatives clearing organization, .~~..~~ . . , including the payment of commissions, brokerage, interest, taxes, storage, and other charges, lawfully accruing in connection with the cleared swap." 7 U.S.C. § 6d(f)(3)(A)(ii).

111 Arthur W. Hahn & Edward J. Zabrocki, *Responsibility for Customer Losses Due to Failure of Correspondent Brokers and Other Depository Institutions*, 71 CHI-KENT L. REV. 1053, 1077-78 (1996).

112 *See, e.g.*, Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations, 78 Fed. Reg. 68,506, 68,510 (Nov. 14, 2013) (to be codified at 17 C.F.R. pt. 1, 3, 22, 30, 140) ("In adopting the amendments to

As initially proposed, the language that became Section 4d of the CEA would have addressed these abuses by providing that an FCM would be required to deal with customer funds "as trust funds."[113] Bills introduced in subsequent sessions also required commission merchants to treat customer funds as trust funds, but they were strongly opposed by the commodities industry, as well as by members of Congress concerned that it would be imprudent to apply a traditional trust concept to complicated market infrastructures without careful study and consideration.[114] Furthermore, without appropriate legislative provisions, such an approach would have interfered with an FCM's ability to commingle funds of multiple customers, to margin customer contracts on a "net" basis, or to pay and receive variation margin in accordance with then-existing clearing organization practices.

As a result of these concerns, the CEA does *not* impose a common-law trust, with its attendant fiduciary obligations, on FCMs holding customer ~~property. Instead, it imposes a "specific statutory trust" over customer funds held by an FCM, with the characteristics set forth in Section 4d.[115] Section 4d mandates that an FCM must~~

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§ 1.25, the Commission was mindful that customer segregated funds must be invested by FCMs and DCOs in a manner that minimizes their exposure to credit, liquidity, and market risks both to preserve their availability to customers and DCOs, and to enable investments to be quickly converted to cash at a predictable value in order to avoid systemic risk."); *see also* Brief of Amicus Curiae, *Futures Industry Association, Inc., in Support of Appellant/Appellee FCStone, LLC's Cross-Appeal and Urging Reversal* at 21*, Grede* v. *FCStone, LLC*, 867 F.3d 767 (7th Cir. 2017) (Nos. 16-1896, 16-1916), 2016 WL 4591973 ("Without immediate access to customer funds, the FCM is hindered in its ability to satisfy margin requirements. In times where there is market disruption, any impediment or restriction upon the ability to immediately withdraw funds 'could magnify the impact of any market disruption and cause additional repercussions.'") (citations omitted).

113 78 CONG. REC. 10,452 (1934) ("Margin moneys collected from customers must be safeguarded and not used to extend credit or to margin trades of any person other than the one for whom held. Such moneys are to be held and treated *as trust funds*, subject to deposit with other members or with the clearing house only as required to margin a customer's trades (sec. 4d added by sec. 5 of bill).") (emphasis added). Congress made several efforts to reform the Grain Futures Act, with the first bill requiring segregation of customer funds being introduced in 1932. *See* H.R. 7608, 72d Cong. § 4C (1932) ("It shall be unlawful for any person to engage in soliciting or accepting orders . . . involving contracts of sale or to sell grain for future delivery . . . unless such person . . . shall keep separate and shall not commingle with his own any of the money, securities, or property received by such person to margin or guarantee the trades or contracts of the customers of such person.").

114 *See* Hahn & Zabrocki, *supra* note 99111, at 1078-79.

~~115 *See, e.g.*, *Grede* v. *FCStone, LLC*, 867 F.3d 767, 780 (7th Cir. 2017) (An FCM's "customers were the beneficiaries of a statutory trust."); *Marchese* v. *Shearson Hayden Stone, Inc.*, 822 F.2d 876, 878 (9th Cir. 1987) ("We also reject Marchese's argument that Shearson violated its duties as a common law trustee by appropriating margin interest without customer consent. The legislative history of the Act makes it clear that section 4d establishes a specific statutory trust, as opposed to a common law trust, and this fact has long been recognized."); *In re Smith*, 72 B.R. 61, 62-63 (Bankr. N.D. Iowa 1987) ("The Court finds that [Section 4d(a)(2) of] the [Commodity Exchange] Act and regulations created a technical trust. . . ."); *see also* Hahn & Zabrocki, *supra* note 71, at 1079 (some members of Congress stated in floor debates that the bill that would become the CEA~~

~~"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."[116]~~ funds.[117] However, in considering the status of customer funds relating to U.S. futures in the context of FCM bankruptcies and the ability of other creditors to reach those funds, courts have found that the effect of the segregation requirement of the CEA and the CFTC's implementing regulations is to create a "specific statutory trust" over customer funds held by an FCM, with the result that those funds should not be entitled to certain protections in the event of the FCM's bankruptcy.[118] These courts have determined that the requirements Section 4d of the CEA and the elaboration of these requirements created by CFTC rules "define the trust res, spell out the trustee's fiduciary duties and impose a trust prior to and without reference to the wrong which created the debt,"[119] thereby creating a "technical trust" – "a trust that is imposed by law and may arise either by statute or common law."[120]

When the CEA was amended by the Dodd-Frank Act to require clearing of swap transactions, the CEA was also amended to provide that an FCM must "treat and

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~~established a trust relationship); MARKHAM, *supra* note 69, at 27 ("The act also established registration requirements for brokerage firms, which are identified in the commodity futures industry as 'futures commission merchants' (FCMs). Customer margins were finally required to be held in trust by FCMs. It was thought that these requirements would eliminate from the market persons unfit to deal with customers."); *To Amend the Grain Futures Act: Hearings on H.R. 6772 Before the S. Comm. on Agriculture and Forestry*, 74th Cong. 113 (1936) (Richard F. Uhlmann, President of the Chicago Board of Trade Clearing Corporation, stated that he'd been advised by counsel that the requirement to treat customer property as belonging to the customer was "practically in a trust relationship to the customer on such money, security, and property.").~~

~~[116] 7 U.S.C. § 6d(a)(2); 17 C.F.R. § 1.20(a) (2020).~~

[117] *See Marchese* v. *Shearson Hayden Stone, Inc.*, 822 F.2d 876, 878 (9th Cir. 1987) ("We also reject Marchese's argument that Shearson violated its duties as a common law trustee by appropriating margin interest without customer consent. The legislative history of the Act makes it clear that section 4d establishes a specific statutory trust, as opposed to a common law trust, and this fact has long been recognized.").

[118] *See, e.g.*, *Grede* v. *FCStone, LLC*, 867 F.3d 767, 780 (7th Cir. 2017) (An FCM's "customers were the beneficiaries of a statutory trust."); *In re Smith*, 72 B.R. 61, 62-63 (Bankr. N.D. Iowa 1987) ("The Court finds that [Section 4d(a)(2) of] the [Commodity Exchange] Act and regulations created a technical trust. . . ."); *see also* Hahn & Zabrocki, *supra* note 99111, at 1079 (some members of Congress stated in floor debates that the bill that would become the CEA established a trust relationship); MARKHAM, *supra* note 97, at 27 ("Customer margins were finally required to be held in trust by FCMs. It was thought that these requirements would eliminate from the market persons unfit to deal with customers."); *To Amend the Grain Futures Act: Hearings on H.R. 6772 Before the S. Comm. on Agriculture and Forestry*, 74th Cong. 113 (1936) (Richard F. Uhlmann, President of the Chicago Board of Trade Clearing Corporation, stated that he'd been advised by counsel that the requirement to treat customer property as belonging to the customer was "practically in a trust relationship to the customer on such money, security, and property.").

[119] *In re Delisle*, 281 B.R. 457, 466 (Bankr. D. Mass. 2002), *aff'd in part and remanded*, No. ADV 01-4391-JBR, 2003 WL 26085842 (B.A.P. 1st Cir. June 9, 2003) (internal quotation marks and citations omitted).

[120] *Id.* (citing *In re Runge*, 226 B.R. 298, 305 (Bankr. D.N.H. 1998)).

deal with all money, securities, and property of any swaps customer received to margin, guarantee, or secure a swap cleared by or through a [DCO] (including money, securities, or property accruing to the swaps customer as the result of such a swap) as belonging to the swaps customer."[121] In ~~both cases~~each case, the FCM must separately account for and not commingle such customer funds with the FCM's funds or use them to margin or guarantee trades or contracts, or secure or extend the credit, of any person other than the relevant customer.[122] As the CFTC has noted, "while the statute and implementing regulations governing FCM customer funds do not use the word 'trust,' the rights and duties they create are precisely the sort that establish a trust both at common law and in other statutory contexts."[123] CEA and CFTC regulations require that customer funds to each account class must be segregated and applied only to obligations arising in respect of that account class; the technical trust relating to cleared swaps must be a separate technical trust from the technical trust relating to U.S. futures.

Because ~~the arrangement is a~~these requirements create statutory, not common-law, ~~trust~~trusts, the rights and duties of the FCM with respect to the segregated assets subject to ~~the~~each "specific statutory trust" are determined by the statute and related regulations, and not by general principles of trust law, and cannot be overridden by the customer agreement.[124] ~~These~~The regulations governing each of these technical trusts permit FCMs to take a number of actions with respect to the assets held in trust that would not be permitted to a typical trustee.[125] For example, both Section ~~6d~~ 4d(a)(2) and

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121 7 U.S.C. § 6d(f)(2)(A); 17 C.F.R. § 22.2(a) (2020). As mentioned above, the CFTC's regulations extend this treatment to the swap transactions themselves as well. Notwithstanding this regulation, it appears that Congress and the CFTC intend that swap transactions shall be cleared in the same manner as futures contracts.

122 7 U.S.C. §§ 6d(a)(2), 6d(f)(2)(B).

123 Brief of Amicus Curiae, *Commodity Futures Trading Commission in Support of Appellant and of Reversal on Selected Issues*, *Grede* v. *FCStone LLC*, 746 F.3d 244 (7th Cir. 2014) (Nos. 13-1232, 13-1278), 2013 WL 2954191; *see also* the testimony of William Bagley, the chairman of the CFTC, remarks in 1976, in which he stated that "[i]n the past, the CFTC and its predecessor agencies have urged that the bankrupt futures commission merchant be treated as a trustee of the funds deposited by his customers to margin their accounts. Under such an approach, the futures commission merchant, and consequently his trustee in bankruptcy, has no ownership interest in customers' funds deposited as margin on their accounts." *Bankruptcy Act Revisions: Hearings on H.R. 31 and H.R. 32 Before the Subcomm. on Civil & Constitutional Rights of the H. Comm. on the Judiciary*, 94th Cong. 2392 (1976). It should be noted that, under the Bankruptcy Code and its predecessor statutes, both express common law trusts and technical trusts of the type described here were sufficient to provide protection from certain provisions of these laws. *See, e.g., In re Halversen*, 330 B.R. 291, 296 (Bankr. M.D. Fla. 2005).

124 *See, e.g., Marchese*, 822 F.2d at 878 (concluding that the terms of the statutory trust are subject to CFTC regulations); *see also* MARKHAM, *supra* note ~~69~~97, at 27 ("At variance with traditional trust principles, 17 C.F.R. §- 1.29 allows FCMs to keep for themselves the interest or other return from . .- . investments [of customer funds].").

125 The Report by the Committee on Agriculture of the House of Representatives on the CEA noted that the CEA was not intended to "interfere with any legitimate business or normal trading activity" but instead was intended to "provide[] for honesty in the conduct of what are important public markets." H.R. Rep. No. 421, at 2-3 (1935).

Section 4(f) and related CFTC regulations permit an FCM to commingle customer funds of different customers in the same account class within the same omnibus account with a bank or a DCO, allow the FCM to invest customer funds in certain types of permitted investments (so long as such investments are maintained on a segregated basis), and permit the FCM to retain for itself the net interest income earned on those investments (which, depending on the interest rate environment and other factors, can be a significant portion of the FCM's overall revenue).[126] In addition, to ensure that the customer funds of one customer are not used to cover the obligations of any other customer, the FCM is permitted to maintain its own funds in a customer segregated account as a cushion in the event of a shortfall due to an undermargined customer; the FCM is also required to deposit its own funds if necessary to cover a shortfall; and the FCM has a "*residual interest*" in funds that are held in the segregated account in excess of those it is required to maintain there.[127]

The FCM may deposit segregated funds relating to U.S. futures only with permitted depositories, which are banks or trust companies (in an omnibus account established by the FCM with its bank for the benefit of the applicable account class), DCOs (in the FCM's U.S. futures omnibus customer margin accounts on the books of the DCOs for the applicable account class),[128] and other registered FCMs (each, a "*depository*"), in each case with account names that clearly identify the funds therein as belonging to the FCM's U.S. futures customers show that the funds are segregated as required by the U.S. futures segregation rules.[129]

To ensure that an FCM complies with the statutory mandate that customer funds "shall not be .~~,~~ . . used to margin or guarantee the trades or contracts, or to secure or extend the credit, of any customer or person other than the one for whom the same are

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126 *See* 17 C.F.R. §§ 1.20, 1.22, 1.25, 1.29 (2020). This regulation is permissive. A customer and its FCM may agree to different arrangements with respect to the allocation of income on segregated assets, so long as the segregation requirement is complied with.

127 *Id.* §- 1.23.

128 The DCO holds the funds of customers of multiple FCMs in a single account with its bank or custodian, but allocates those funds to the respective FCMs on the books of the DCO, in a manner similar to the way in which the FCM commingles funds of multiple customers in the accounts that it maintains with its banks and custodians but credits individual customers with their respective shares of such funds.

129 The term "*segregated account*" means an account maintained by the FCM with an individual depository to hold segregated funds for the benefit of customers in the applicable account class. The FCM may maintain more than one segregated account; all the segregated accounts (on a combined basis) maintained by the FCM with all depositories that hold segregated funds in respect of the account class are treated as a single fund relating to the relevant account class. Generally, a DCO will designate a limited number of banks or trust companies that they themselves use as settlement banks and the FCM will pick one on the DCO's list as the FCM's settlement bank for that DCO. To the extent possible, the FCM will typically select a settlement bank that it can use across DCOs in respect of the same account class and currency. For example, the FCM may select the New York branch of a bank for USD and the London Branch of the bank for currencies other than USD.

held," the CFTC has imposed strict limitations on the use of customer funds by an FCM.[130] On a day-to-day basis, an FCM is required to deposit any funds received from a customer to margin its customer transactions, and any amounts received from a DCO in respect of the customer's ~~customer~~ transactions, in a segregated account maintained with a "permitted depository~~."[131]~~" for customers of the applicable account class.[132] As noted above, the FCM may commingle the funds of its customers in an account class in a single account or multiple accounts, and may draw upon the aggregate customer funds held in segregation for an account class to meet margin calls and other costs and expenses required to margin, guarantee, secure, transfer, adjust, or settle the customer transactions of the relevant customer in that account class, including those payable as a result of the customer's default.[133] Only those expenses "necessary to the execution of commodity trades and maintenance of any resulting positions" in an account class may be debited from the customer funds held in segregation~~;[134]~~ for that account class; other costs and expenses (including, for example, commissions payable to an introducing broker in respect of customer transactions) that are chargeable to the customer ~~must~~ ("*chargeable costs*") may be debited from the customer's account~~,~~ (reducing the FCM's debt to the customer and the amount of funds it must hold in segregation), but may not be taken directly from the segregated funds.[135]

Because it is not possible to trace any particular ~~funds~~assets held in ~~the commingled segregated~~ segregation for an account class to any particular customer,[136] a

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130 7 U.S.C. §§ 6d(a)(2), 6d(f)(2)(B); *see also* CFTC, Deposit of Offshore Funds in Offshore Depository (Aug. 1, 1988), No. 88-14, 1988 WL 485396, at *1.

~~131 The permitted depositories are a bank or trust company, a DCO, or another FCM. 17 C.F.R. §§ 1.20(b); 22.3(b) (2020).~~

132 The permitted depositories are a bank or trust company, a DCO, or another FCM. 17 C.F.R. §§ 1.20(b); 22.3(b) (2020).

133 *See generally* the discussion of the margining process in William Bagley's testimony in *Bankruptcy Act Revision: Hearings on H.R. 31 and H.R. 32 before the Subcomm. on Civil & Constitutional Rights of the H. Comm. on the Judiciary*, 94th Cong. 2398 *et seq.* (1976).

~~134 CFTC Division of Trading and Markets, Financial and Segregation Interpretation No. 14 on Accounting for Deposits and Contractual Obligations Between an FCM and Its Introducing Brokers and Associated Persons, *available at* https://www.cftc.gov/sites/default/files/tm/tmint-14.htm.~~

135 CFTC Division of Trading and Markets, Financial and Segregation Interpretation No. 14 on Accounting for Deposits and Contractual Obligations Between an FCM and Its Introducing Brokers and Associated Persons, *available at* https://www.cftc.gov/sites/default/files/tm/tmint-14.htm.

136 *Cf. Bankruptcy Act Revisions: Hearings on H.R. 31 and H.R. 32 before the Subcomm. on Civil & Constitutional Rights of the H. Comm. on the Judiciary*, 94th Cong. 2398 (1976) ("As a result of this permissible commingling of the funds of commodity customers with those of the futures commission merchant, however, it may be much more difficult for a trustee in bankruptcy to trace or identify customers' money, securities, and property in the event of the bankruptcy of the futures commission merchant."). Chairman Bagley further noted that because the "CE Act and CFTC regulations permit house funds to be commingled with customers' funds, .~~.~~ . . general creditors of the bankrupt futures commission merchant might be able to argue successfully that the bankrupt futures commission merchant did not hold commodity customers' funds in trust for such

customer of an FCM with customer funds held in segregation for an account class does not have a property interest in any particular asset held in segregation, but rather has an undivided fractional interest in the assets held in segregation overall for that account class.[137] The CFTC has adopted regulations by which the interest of any particular customer, ~~and~~ customers generally, and ~~those of~~ the FCM in the segregated account for an account class are determined from time to time. Under CFTC Rule 1.32, an FCM must determine on a daily basis the total amount of segregated funds in each currency that it holds on account for U.S. futures customers generally, and for each such customer individually, as well as the FCM's residual interest in such segregated funds.[138] Rule 22.2(f)(6)(ii) establishes parallel requirements for the segregated funds.~~[139] Under Rule 1.20, the amount that the FCM must maintain in segregation with respect~~ relating to ~~each customer is equal to the~~ cleared swaps.[140]

Under Rule 1.20, the amount that the FCM must maintain in segregation with respect to each U.S. futures customer is equal to the value of any futures customer funds that it receives from such customer in relation to U.S. futures, as adjusted by:

(i) Any ~~permitted use~~Permitted Use of the customer's funds~~, as discussed below;~~ in connection with U.S. futures;

(ii) Any accruals on permitted investments of the customer's ~~funds~~customer funds held in relation to U.S.

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customers in any traditional sense and that therefore no preference should be allowed." *Id.* at 2393. Given the critical importance of ensuring the availability of customer funds for their intended purpose in the event of the FCM's failure and the difficulty of tracing any funds to any particular customer, the CFTC sought the amendments made to the Bankruptcy Code in 1976 to provide a statutory priority for customers in the segregated customer funds, without requiring any tracing of those funds by any particular customer. Congress subsequently provided a clear statutory priority for customers in the segregated customer funds in an FCM failure.

137 Brief of Amicus Curiae, *Commodity Futures Trading Commission in Support of Appellant and of Reversal on Selected Issues* at 10, *Grede* v. *FCStone LLC*, 746 F.3d 244 (7th Cir. 2014) (Nos. 13-1232, 13-1278), 2013 WL 2954191. ("Taken together, these two provisions show that Congress contemplated that customer funds covered by section 6d would sometimes, if not usually, take the form of an undivided interest in a body of assets whose individual components would vary, and that the protections of the section extend to such interests.").

138 17 C.F.R. § 1.32(a). If a particular customer has deposited securities with the FCM as margin, the FCM is permitted to offset any net debit balance in the customer's account against the value of those securities (subject to valuation haircuts). *Id.* § 1.32(b). The corresponding provision for cleared swaps provides that the FCM must maintain in segregation "an amount equal to the sum of any credit balances that the Cleared Swaps Customers of the futures commission merchant have in their accounts." *Id.* § 22.2(f)(4).

~~139 17 C.F.R. § 1.32(a) (2020). If a particular customer has deposited securities with the FCM as margin, the FCM is permitted to offset any net debit balance in the customer's account against the value of those securities (subject to valuation haircuts). *Id.* § 1.32(b).~~

140 *Id.* § 22.2(f)(6).

futures that, pursuant to the customer agreement with that customer, are creditable to such customer;

(iii) Any gains and losses with respect to customer ~~transactions~~U.S. futures;

(iv) Any charges lawfully accruing to the customer, including any commission, brokerage fee, interest, tax, or storage fee in connection with U.S. futures; and

(v) Any appropriately authorized distribution or transfer of the customer's funds.[141]

The parallel calculation for cleared swaps is contained in CFTC Rule 22.2(f)(ii).

In sum, ~~"~~each FCM must segregate sufficient funds to cover any amounts it owes to its customers in connection with ~~commodity interest~~ transactions~~."~~ in the relevant account class.[142] If the funds in segregation are not sufficient to satisfy the requirement, the FCM must make up the shortfall with its own funds. Any segregated funds on deposit contributed by the FCM in excess of the required amount for an account class — *i.e.*, the FCM's *"residual ~~financial~~ interest~~"~~"*[143] — constitutes property of the FCM. The claims of the customers of an account class for their customer funds, together with the FCM's residual interest, constitute the entirety of the entitlements to the segregated funds of such account class. The extent of each customer's entitlement to the segregated funds for that account class is limited to a monetary value equal to its net liquidating equity, which the CFTC views as representing the FCM's total obligations to the customer in respect of such account class. Accordingly, to the extent that the FCM is entitled to charge the customer under the customer agreement for a ~~fee,~~chargeable cost ~~or charge~~, but is not permitted to debit the segregated funds directly for that amount, the FCM may debit the customer's ~~customer~~ account and, by charging the customer account for these chargeable costs, and reducing the FCM's liability to the customer in respect of the customer account balance accordingly, the customer's interest in the funds held in segregation is also reduced by the relevant amount.[144]

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141 *Id.* § 1.20(i)(2).

142 CFTC Division of Trading and Markets, Obligations of FCM (Nov. 22. 2000), Letter No. 00-106, 2000 WL 1753649; *see also* Securities Representing Investment of Customer Funds Held in Segregated Accounts by Futures Commission Merchants, 62 Fed. Reg. 42,398, 42,398 (Aug. 7, 1997) (to be codified at 17 C.F.R. pt. 1) ("At all times, an FCM is required to have sufficient funds in segregation to meet its obligations to customers.").

143 17 C.F.R. § 1.23(c~~) (2020~~), 22.2(e)(4).

144 Financial and Segregation Interpretation No. 14, *supra* note ~~87~~119 ("This limitation on recovery does not result in a windfall to the customer who does owe the commissions, however, *because the FCM's liability to that customer*, and hence the money payable to that customer in bankruptcy, must be reduced by the amount of commissions earned, but not yet charged to that customer's

VII. STRUCTURE OF THE RELATIONSHIP ~~AMONG~~AMONG PARTIES IN FOREIGN FUTURES ~~TRANSACTIONS~~

The CEA authorizes the CFTC to adopt regulations proscribing fraud and establishing financial standards and other prudential requirements applicable to any person in the United States that offers or sells U.S. futures or options on futures contracts on or subject to the rules of a foreign board of trade or exchange. The CFTC is given significant latitude in determining the content of those rules, including the right to adopt different requirements depending upon the foreign market involved, but does not have the authority to approve ~~the foreign~~such contracts or regulate the foreign boards of trade.[145] Further, Section 738 of the Dodd-Frank Act gave the CFTC the authority, which the CFTC has exercised, to require registration of foreign boards of trade that provide direct access to U.S. persons.[146] The CFTC has exercised this authority by promulgating rules governing the offer and sale of foreign futures ~~contracts~~ to customers located in the United States.[147] While these rules are separate from those governing the offer and sale of domestic derivatives products, the CFTC has indicated that these rules are "designed to carry out Congress's intent that foreign futures and foreign options products offered or sold in the U.S. be subject to regulatory safeguards comparable to those applicable to domestic transactions."[148]

Under these rules, two primary models exist through which ~~U.S.~~ customers trade in foreign futures ~~contracts~~. Many FCMs clear and carry foreign futures ~~contracts~~ for ~~their~~both U.S. and foreign customers~~,~~ who transact in these contracts (such customers, "*foreign futures customers*"), in addition to or in lieu of U.S. futures and cleared ~~customer contracts (which, for purposes of this memorandum, include only futures contracts and cleared swap contracts).~~swaps. In general, FCMs do so by engaging a foreign futures broker regulated under the laws of the jurisdiction in which the clearing organization is located to execute, clear and carry the foreign futures ~~contracts~~ on the FCM's behalf, for the benefit of the FCM's foreign futures customers. If necessary, that foreign futures broker may engage another foreign futures broker to the extent required to permit trading on all relevant foreign markets. Alternatively, a foreign futures broker may deal with a customer directly.[149]

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account, *thereby reducing such customer's claim against assets segregated for customers generally*." (emphasis added)).

145 7 U.S.C. § 6(b).

146 *See* Pub. L. No. 111-203, § 738, 124 Stat. 1376, 1726-28 (2010); 17 C.F.R. § 48.1. It is important to note, however, that the CFTC's authority to require registration of foreign boards of trade is separate and distinct from the regulation of the offer and sale of foreign futures in the United States.

147 17 C.F.R. § 30.1, *et seq.* (2020).

148 CFTC, *Foreign Markets, Products & Intermediaries*~~, CFTC~~, *available at* https://www.cftc.gov/International/ForeignMarketsandProducts/foreignprodsales.html.

149 ~~An FCM may also~~ Insofar as U.S. regulations are concerned, an FCM is permitted to clear foreign futures transactions directly on a foreign clearing organization, without the involvement of

In either case, trading in foreign futures ~~contracts~~ raises questions both under ~~both New York~~U.S. state and federal law, and under the laws of the jurisdiction under which the relevant exchange and clearing organization are regulated. This memorandum does not describe or analyze the law of any foreign jurisdiction; however, it does seek to indicate when foreign law may be important in characterizing the relationships among the parties ~~to a~~involved in foreign futures ~~transaction~~.

A. Clearing Foreign Futures ~~Contracts~~ Through an FCM

The general approach of the CEA and the CFTC's regulations regarding trading of foreign futures ~~contracts~~ through an FCM is to apply a structure similar to that which governs the ~~trading~~handling of ~~domestic~~U.S. futures ~~and options~~ for customers, involving registration, disclosure and isolation of customer assets, although there are some differences to take account of the foreign market nexus. Generally, though subject to exceptions, the CFTC's rules require that any entity that solicits or accepts orders involving foreign futures ~~contracts or foreign option transactions~~, and accepts money, securities or property to margin, guarantee or secure any trades or contracts in connection with such solicitation or acceptance, must be registered with the CFTC as an FCM or qualify for the foreign futures broker exemption.[150]

In some respects, the relationships among the parties involved in the execution and clearing of ~~a~~ foreign futures ~~transaction~~ by a U.S. customer through an FCM are similar to those described in the ~~domestic cleared~~context of U.S. futures ~~contract context~~, but there are a number of significant differences, including the role of foreign law in determining customer rights. In fact, the risk disclosure statement that the CFTC requires FCMs to furnish to foreign futures customers emphasizes that non-U.S. law and regulation may affect the rights and obligations of U.S. customers in relation to foreign futures ~~transactions~~:

> Foreign futures transactions involve executing and clearing trades on a foreign exchange. This is the case even if the foreign exchange is formally "linked" to a domestic exchange, whereby a trade executed on one exchange liquidates or establishes a position on the other exchange. No domestic organization regulates the activities of a foreign exchange, including the execution, delivery, and clearing of transactions on such an exchange, and no domestic regulator has the power to compel enforcement of the rules of the foreign exchange or the laws of the foreign country. Moreover, such laws or regulations will vary

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a foreign futures broker. Based on current market practice, however, it is unusual for a foreign futures transaction to be cleared and executed without an intermediary foreign futures broker. Therefore, this memorandum does not analyze this scenario.

150 17 C.F.R. § 30.4(a) (2020); *see infra* Section VII.B (discussing the clearing of foreign futures by foreign futures brokers under the exemption from registration provided by Rule 30.10).

depending on the foreign country in which the transaction occurs. For these reasons, customers who trade on foreign exchanges may not be afforded certain of the protections which apply to domestic transactions, including the right to use domestic alternative dispute resolution procedures. In particular, funds received from customers to margin foreign futures transactions may not be provided the same protections as funds received to margin futures transactions on domestic exchanges. Before you trade, you should familiarize yourself with the foreign rules which will apply to your particular transaction.[151]

B. Typical Scenario for Executing and Clearing Foreign Futures ~~Transactions~~ Through a U.S. FCM

Figure 2

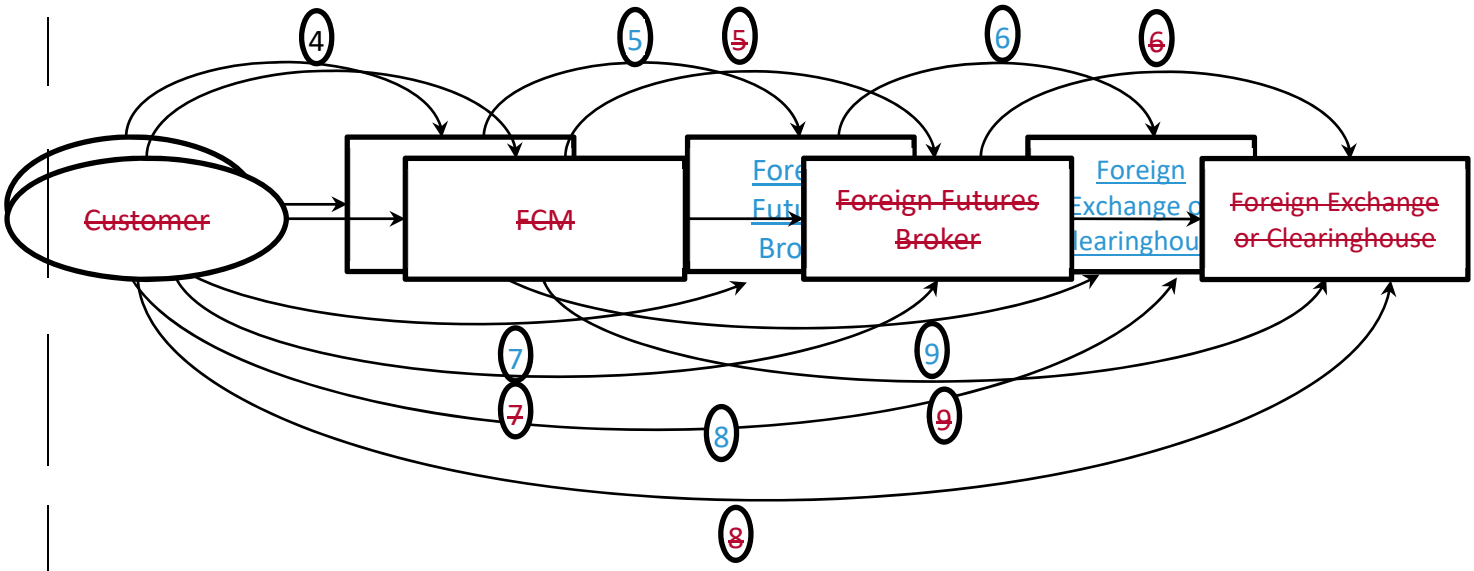

Figure 2 above depicts the typical way in which a ~~U.S. customer completes a~~ foreign futures customer executes a transaction in foreign futures through an FCM.

The relationship between the foreign futures customer and the FCM is labeled "4" above. First, the foreign futures customer enters into a contractual arrangement with an FCM[152] and provides money, securities or other property to the FCM to fund its foreign futures account. The FCM is not permitted to hold these ~~funds~~or

151 17 C.F.R. § 1.55(b)(13) (2020).

152 In many cases, the customer agreement will provide for foreign futures and options trading as well as domestic futures and options trading.

other customer funds relating to foreign futures ("*foreign futures customer funds*") in the segregated accounts used to hold customer funds relating to ~~domestic~~U.S. futures ~~and options trading~~ or cleared ~~swap contracts~~swaps, respectively.[153] Rather, pursuant to Rule 30.7, the FCM is required to maintain a "separate account" or "separate accounts" (collectively, the "*foreign futures separate account*") in which the FCM must maintain funds in an amount at least sufficient to cover or satisfy all of its current obligations to ~~the~~ foreign futures customers ~~engaging in these transactions; this amount is referred to as~~ (the "*foreign futures ~~and foreign options secured amount.~~"secured amount.")[154] As is the case with respect to ~~domestic~~ U.S. futures and cleared ~~customer transactions~~swaps, the customer, as principal, has the right to instruct the FCM to execute trades on its behalf. The foreign futures customer agrees, in the customer agreement, to provide margin to the FCM in accordance with the FCM's policies, to pay commissions and fees to the FCM, and to reimburse or indemnify the FCM for any costs or liabilities incurred by the FCM in the course of providing services under the customer agreement. Similarly, the FCM, as the foreign futures customer's agent, has the duty to execute and clear foreign futures ~~contracts~~ on behalf of the foreign futures customer on a foreign exchange or through a foreign clearing organization, and to account to the foreign futures customer for the foreign futures ~~contracts~~ executed or cleared on the foreign futures customer's behalf.

As noted above, typically, an FCM is not a clearing member of the relevant foreign exchange or clearinghouse. Instead, the FCM enters into a contractual relationship with, and holds an account—a "*foreign futures customer omnibus account*~~"~~"—on behalf of, its foreign futures customers at a foreign futures broker in the relevant jurisdiction that maintains the required clearing membership.[155] The foreign

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[153] ~~17 C.F.R § 30.7(e)(3) (2020).~~ 17 C.F.R § 30.7(e)(3). "Customer funds," in relation to foreign futures, means "any money, securities, or other property received by a futures commission merchant from, for, or on behalf of 30.7 customers to margin, guarantee, or secure foreign futures or foreign option positions, or money, securities, or other property accruing to 30.7 customers as a result of foreign futures and foreign option positions." *Id.* § 30.1(h).

[154] ~~*Id.* § 30.7(a).~~ *Id.* § 30.7(a). "Foreign futures or foreign options secured amount" (referred to in this memorandum as the foreign futures secured amount) means "all money, securities and property received by a futures commission merchant from, for, or on behalf of [foreign futures] customers as defined in § 30.1 of this chapter: (1) To margin, guarantee, or secure foreign futures contracts and all money accruing to such [foreign futures] customers as the result of such contracts; (2) In connection with foreign options transactions representing premiums payable or premiums received, or to guarantee or secure performance on such transactions; and (3) All money accruing to such [foreign futures] customers as the result of trading in foreign futures contracts or foreign options." *Id.* 1.3.

[155] Foreign brokers that are either registered as FCMs or operating under the exemption afforded under Rule 30.10 can carry foreign futures accounts directly for U.S. persons. Based on our understanding, typical market practice is for the foreign futures broker not to be registered with the CFTC. Rule~~*See generally id.* § 30.10. Part~~ 30.10(a) ~~notes that~~allows "[a]ny person adversely affected by any requirement" of the Part 30 rules ~~can~~to petition for an exemption, and the CFTC "may, in its discretion, grant such an exemption if that person demonstrates to the [CFTC's] satisfaction that the exemption is not otherwise contrary to the public interest or to the purposes of the provision from which exemption is sought." ~~*Id.* § 30.10(a). Part~~Rule 30.10(b) provides ~~certain~~ conditions that a foreign person petitioning for an exemption must meet if that foreign person has

futures customer omnibus account is held in the name of the FCM on the books of the foreign futures broker, which may, but is not required to, be an affiliate of the FCM. When the FCM receives an order from a foreign futures customer to execute a transaction in foreign futures ~~transaction~~, the FCM instructs the foreign futures broker at which it holds a foreign futures customer omnibus account to execute the transaction on its behalf; the foreign futures broker clears the transaction on behalf of the FCM at the relevant foreign exchange or clearinghouse, and carries the resulting foreign futures transaction in the foreign futures customer omnibus account. The FCM reflects the foreign futures ~~transactions~~ carried in the foreign futures customer omnibus account in the customer accounts of the ~~customer~~foreign futures customers for which it instructed the foreign futures broker to execute the ~~trade~~transactions. The foreign futures customer is the beneficial owner of the ~~customer~~ transactions carried in its customer account, and is entitled to the benefit and subject to the burdens of ~~the customer~~those transactions.

~~The~~In Figure 2 above, the relationship between the FCM and the foreign futures broker is labeled "5~~" in Figure 2 above,~~," and the relationship between the foreign futures broker and the foreign exchange or clearinghouse is labeled "6~~" in Figure 2 above. The nature of the~~." The relationship between the FCM and the foreign futures broker is governed by a contract between the FCM and the foreign futures broker, ~~which~~and the relationship between the foreign futures broker and the foreign exchange or clearinghouse will be governed by the rules of that exchange or clearinghouse and any related contract. Each of these contracts and the rules will likely be subject to non-U.S. law—the law governing the foreign futures broker or the clearing organization and its contracts—and not by New York and/or federal law.[156] Similarly, if the foreign futures broker clears the foreign futures transactions through another broker, the nature of the relationship (if any) between the FCM and that foreign futures broker, and the relationship between the first foreign futures broker and the second, would also likely be governed by non-U.S. law. As noted above, we have assumed that, pursuant to the customer agreement between the foreign futures customer and the FCM, the foreign futures customer agrees to the application of such foreign law to the relevant foreign futures ~~contracts~~.

The lines labeled "7" and "8" ~~above~~in Figure 2 reflect the relationship that may exist between a foreign futures customer and ~~the~~a foreign futures broker and foreign

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a presence in the United States through U.S. bank branches or divisions. ~~Typically, the foreign broker is not required to be registered with the CFTC. *See id.* § 30.4(a). Part~~Rule 30.4(a) provides that a foreign futures broker is not required to register as an FCM: (1)~~-~~ in order to accept orders from or to carry a U.S. FCM's foreign futures customer omnibus account, (2)~~-~~ in order to accept orders from or to carry a U.S. FCM's proprietary account, and~~/~~/or (3)~~-~~ in order to accept orders from or carry a U.S. affiliate account which is proprietary to the foreign futures broker. *See generally id.* § 30.10.

156 Although governed by foreign law, the agreement between the FCM and the foreign futures broker must satisfy the requirements of the CEA and the CFTC's regulations, including the establishment of the foreign futures customer omnibus account and compliance with the requirements of Rule 30.7.

clearing organization, respectively. If the foreign futures customer trades in foreign futures through its FCM~~, rather than~~ (as opposed to dealing with ~~the~~a foreign futures broker directly~~,~~), then insofar as U.S. law is concerned, there is no direct relationship between the foreign futures customer and either the foreign futures broker or the foreign clearing organization;[157] however, because the foreign futures customer has agreed to be bound by the agreement between the FCM and the foreign futures broker and the rules of the foreign clearing organization, it is theoretically possible that such a relationship could exist.

Similarly, if the FCM executes the ~~customer transactions~~foreign futures through a foreign futures broker, then insofar as U.S. law is concerned, there is no direct relationship between the FCM and the foreign clearing organization (labeled "9" in Figure 2 above) or any intermediate foreign futures broker with whom the foreign futures broker may execute the customer transactions. The FCM does not transact directly with the foreign clearing organization and is not a clearing member. Rather, the FCM has an account with the foreign futures broker, which in turn is a clearing member of the relevant exchange or clearinghouse, and the FCM is a customer of the foreign futures broker. The agreement between the first foreign futures broker and the second foreign futures broker or the rules of a foreign clearing organization could theoretically establish such a relationship, but again, we are not aware of any clearing organization that has established a direct nexus with the FCM.

C. Recognition of the Foreign Law Governing Agreements with a Foreign Futures Broker or Foreign Clearinghouse Rules

In general, the courts of the State of New York will honor a contractual choice of another jurisdiction's governing law so long as the jurisdiction in question bears a "reasonable relationship" to the contract or the transactions entered into pursuant to the relevant contract, unless the contract or such transactions violate a fundamental public policy either of the State of New York or of another state or country whose law would apply in the absence of a governing law provision and that has a materially greater interest in the determination of the issue presented.[158] To the extent that the law chosen to govern an agreement between an FCM and a foreign futures broker is the law of the jurisdiction in which that broker maintains the foreign futures customer omnibus account, and the law chosen to govern the rules of a foreign clearing organization is the law of the jurisdiction in which that foreign clearing organization operates, we believe that these facts alone would generally constitute a "reasonable relationship" to that jurisdiction. Accordingly, subject to the foregoing and assuming that the relevant contract or rules do not violate a fundamental policy of the United States or of another state or country whose

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157 Foreign futures brokers that have established a direct nexus with the customer are regulated under Rule 30.10 as discussed in Section VII.C below.

158 *See Eastern Artificial Insemination Coop.* v. *La Bare*, 210 A.D.2d 609 (1994); *Culbert* v. *Rols Capital Co.*, 184 A.D.2d 612 (1992); *Monsanto* v. *Elec. Data Sys. Corp.*, 141 A.D.2d 514, 515 (1988); *A.S. Rampell Inc.* v. *Hyster Co.*, 3 N.Y.2d 369, 381 (1957); *Compania de Inversiones Internacionales* v. *Industrial Mort. Bank of Finland*, 269 N.Y. 22, 26 (1935).

law would apply in the absence of a governing law provision and that has a materially greater interest in the determination of the issue presented, we believe that the courts of the State of New York would honor the choice of such foreign law to govern such agreement or rules.

If the choice of law made in an agreement is enforceable by the courts of the State of New York, a federal court sitting in New York that hears a contractual dispute pursuant to its diversity jurisdiction would also be obligated to enforce that choice of law.[159]

Moreover, a bankruptcy court determining the rights of an FCM under the customer agreement would also generally respect an otherwise enforceable provision in the customer agreement agreeing to the application of foreign law to govern the agreement with the foreign futures broker or the rules of the central counterparty. Unlike a federal court exercising its diversity jurisdiction, a bankruptcy court is not always required to follow the choice of law rules of the state in which it sits.[160] However, in *Butner* v. *United States*,[161] the Supreme Court held that, as a general matter, under Title 11 of the Bankruptcy Code:

> Property interests are created and defined by state law. Unless some Federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding. Uniform treatment of property interests by both state and Federal courts within a State serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving 'a windfall merely by reason of the happenstance of bankruptcy.'[162]

Although the *Butner* decision addressed whether the rights of a mortgagee should be determined pursuant to state law, rather than the enforceability of a contractual choice of law, the same principle normally would require a court to determine the rights of the parties to an agreement in accordance with the law applicable outside of bankruptcy, subject to any inconsistent provisions in the Bankruptcy Code.[163]

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159 *See Klaxon Co.* v. *Stentor Elec. Mfg. Co.*, 313 U.S. 487, 496 (1941) (U.S. Federal court sitting in diversity must apply choice of law rules of state in which court is located).

160 *See, e.g.*, *In re Koreag, Controle et Revision S.A.*, 961 F.2d 341, 350 (2d Cir. 1992) (finding that certain issues under Bankruptcy Code "involving important concerns implicating national bankruptcy policy" require application of Federal choice of law doctrine), *cert. denied*, 506 U.S. 865 (1992).

161 440 U.S. 48 (1979).

162 *Id.* at 55 (quoting *Lewis* v. *Manufacturers Nat'l Bank*, 364 U.S. 603, 609 (1961)).

163 *See Barnhill* v. *Johnson*, 503 U.S. 393, 398 (1992) (referring to state law to determine property interests of parties to transactions involving bank checks); *In re Woodcock*, 45 F.3d 363, 366 (10th

There is no provision of the FDIA, the National Bank Act, as amended (the "*National Bank Act*~~" or the "*NBA*"~~"), or the New York Banking Law, as amended (the "*NYBL*~~"),~~"), that expressly grants the FDIC, the Office of the Comptroller of the Currency (the "*OCC*") or the New York Superintendent of Financial Services (the "*Superintendent*~~"~~") (or a conservator or receiver appointed by the OCC or the Superintendent) the authority to override an otherwise valid choice of law agreement to which an insolvent institution is a party. Under the FDIA, the FDIC steps into the shoes of an insolvent depository institution with respect to each contract,[164] and is required to "work out its claims under state law," unless the FDIC is granted the power to do otherwise by statute.[165] ~~The National Bank Act does not grant a conservator or receiver appointed under its provisions the authority to disregard an otherwise valid provision of a contract to which a national bank is a party.~~ Similarly, the Superintendent or any other entity appointed as receiver under the NYBL stands in the shoes of an insolvent institution in relation to contracts to which that institution is a party when the Superintendent takes possession, except to the extent otherwise permitted by statute.[166] Accordingly, to the extent that the choice of law to govern the agreement with the foreign futures broker or the rules of the foreign clearing organization is enforceable as a matter

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Cir. 1995) (applying state law to interpret promissory notes); *cf. In re Columbia Gas Sys. Inc.*, 50 F.3d 233, 238 (3d Cir. 1995) ("Generally, application of the Bankruptcy Code does not change the attributes of a given legal relationship. Thus, if the settlement agreement should be considered a contract under relevant nonbankruptcy law, it will be a contract in bankruptcy unless some federal interest requires a different result .~~.~~ ." (internal quotation marks and citations omitted)).

164 *See* 12 U.S.C. §~~-~~ 1821(d)(2)(A)(i).

165 *O'Melveny & Myers* v. *Fed. Deposit Ins. Corp.*, 512 U.S. 79, 87 (1994); *accord Athereton* v. *Fed. Deposit Ins. Corp.*, 519 U.S. 213, 213-14 (1997); *Resolution Trust Corp.* v. *Coopers & Lybrand*, 915 F. Supp. 584, 588 (S.D.N.Y. 1996); *see also* 12 U.S.C. §~~-~~ 1819(b)(2)(D) (providing that cases that involved "only the preclosing rights against the State insured depository institution, or obligations owing to, depositors, creditors, or stockholders by the State insured depository institution" shall not be deemed to arise under the Federal law). Section 1819(b)(2)(D) has been interpreted to require the FDIC to apply state law in its determination of claims as receiver for a state bank. *See Tosco Corp.* v. *Fed. Deposit Ins. Corp.*, 723 F.2d 1242, 1246-47 (6th Cir. 1983); *Fed. Deposit Ins. Corp.* v. *Braemoor Assocs.*, 686 F.2d 550, 553-54 (7th Cir. 1982).

166 *See Banco De Desarrollo Agropecuario, S.A.* v. *Gibbs*, 709 F. Supp. 1302, 1305 (S.D.N.Y. 1989) ("Generally, a receiver stands in the shoes of a corporation and can assert only those claims which the corporation itself could have asserted."); *see also Federation Bank & Trust Co.* v. *Hammons*, 26 N.Y.S.2d 56 (Sup. Ct. 1941) (agreement made between defendant and superintendent of banks while in possession of plaintiff bank, which agreement would be void as against public policy if made between defendant and plaintiff bank itself, cannot be endowed with legality where made by the superintendent who had no statutory authority to make such agreements); *Yokohama Specie Bank, Ltd.* v. *Nat'l City Bank of New York*, 44 N.Y.S.2d 463, 465 (N.Y. City Ct. 1943) (stating that it "seems implicit in section 619 of the [NYBL] that actions by the Superintendent must be those which the bank itself could have maintained"), *rev'd on other grounds*, 52 N.Y.S.2d 97 (N.Y. App. Term 1944); *Lafayette Trust Co.* v. *Beggs*, 213 N.Y. 280, 284 (1915) (stating that the Superintendent of Banks "is clothed with all of the powers and duties of a receiver is apparent from an examination of the" NYBL in force at the time).

of applicable non-insolvency law, we believe it would also be enforceable in a bank insolvency under the FDIA.

D. Structure of the Foreign Futures Separate Account ~~Structure~~

As noted above, the CFTC's rules require that an FCM establish one or more foreign futures separate accounts in which it holds foreign futures customer funds relating to its ~~U.S.~~ foreign futures customers ~~who trade~~in connection with their trading in foreign futures contracts ~~("*30.7 customers*"). The~~. The foreign futures separate account cannot be commingled with the FCM's own property or either of the segregated ~~account~~accounts maintained in connection with U.S. futures or cleared ~~customer transactions.~~swaps, unless expressly permitted by the CFTC.[167] The relevant CFTC rule states that the FCM "must at all times maintain *in a separate account or accounts* money, securities and property in an amount at least sufficient to cover or satisfy all of its obligations to ~~30.7~~[foreign futures] customers denominated as the ~~foreign futures or~~ [foreign ~~options~~futures secured amount~~."~~]."[168] The foreign futures secured amount must be held under an account name that clearly identifies the funds as belonging to ~~30.7~~foreign futures customers and that shows that the foreign futures secured amount is set aside as required by CFTC rules.[169]

~~It should be noted that the amount required to be held in the separate account may be substantially less than the amount that would be required if the same contract were subject to the domestic segregation requirements. As the CFTC noted in 2013,~~

> ~~. . . unlike § 1.20 and part 22, which require an FCM to hold a sufficient amount of funds in segregation to meet the total account equities of all of the FCM's futures customers and Cleared Swaps Customers "at all times" (*i.e.*, the "Net Liquidating Equity Method"), § 30.7 requires an FCM to maintain in separate accounts an amount of funds only sufficient to cover the margin required on open foreign futures contracts, plus or minus any unrealized gains or losses on such open positions, plus any funds representing premiums payable or received on foreign options (including any additional funds necessary to secure such options, plus or minus any unrealized gains or losses on such options) (*i.e.*, the "Alternative Method"). Thus, under~~

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167 17 C.F.R. § 30.7(e)(3).

168 ~~17 C.F.R. §~~ *Id.* § 30.7(a) ~~(2020)~~ (emphasis added). "*Foreign futures or foreign options secured amount*" is defined in 17 C.F.R. § 1.3 to mean "all money, securities and property received by a futures commission merchant from, for, or on behalf of" U.S. customers who trade in foreign futures contracts.

169 *Id.* § 30.7(b).

~~the part 30 Alternative Method an FCM is not required to maintain a sufficient amount of funds in such separate accounts to pay the full account balances of all of its foreign futures or foreign options customers at all times.[170]~~

The CFTC allows some flexibility as to where the foreign futures secured amount can be held, including at a United States bank or trust company, a bank or trust company located outside of the United States that has in excess of $1- billion in regulatory capital, a CFTC-registered FCM, a DCO, the clearing organization of a foreign board of trade, a member of a foreign board of trade, or such member's or clearing organization's designated depositories.[171] However, an FCM can ~~only~~ hold the foreign futures secured amount in accounts maintained outside of the United States only in an amount sufficient to meet margin requirements ~~(including such prefunding requirements)~~ established by foreign boards of trade or foreign clearing organizations, or to meet margin calls issued by foreign futures brokers carrying the 30.7 customers' foreign futures and option positions.[172] Further, deposits of foreign futures customer funds made outside the United States under Rule 30.7 must be made pursuant to the laws and regulations of the foreign jurisdiction that provide "the greatest degree of protection to such funds."[173]

The rules governing the separate account structure parallel the provisions of Section- 4d(2) and the related CFTC regulations in many respects, including (1) requiring that the funds be recognized as "belonging to" foreign futures customers,[174] (2) permitting the FCM to commingle the funds of multiple foreign futures customers in a single separate account,[175] (~~2~~3) prohibiting the FCM from commingling the funds in the separate account with its own funds except as expressly permitted,[176] (~~3~~4) prohibiting the use of one foreign futures customer's funds to purchase, margin or settle the trades, contracts, or commodity options of, or to secure or extend credit to, any person other than

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~~170~~ ~~Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations, 78 Fed. Reg. 68,505, 68,508 (Nov. 14, 2013) (to be codified at 17 C.F.R. pt. 1, 3, 22, 30, 140).~~

171 ~~17 C.F.R. §~~ *Id.* § 30.7(b~~) (2020~~). Rule 30.7(d) requires an FCM to receive a written acknowledgement from depositories in the applicable form set out in Appendix E to Rule 30. *Id.* §- 30, Appendix E. The acknowledgement requires that an FCM may deposit customer funds only with a depository that agrees to various supervisory and recordkeeping obligations to the CFTC and self-regulatory organizations. *Id.* §§ 30.7(d)(3)-(8).

172 *Id.* §- 30.7(c). Additionally, an FCM may deposit an additional amount of up to 20 percent of the total amount of funds necessary to meet margin and prefunding margin requirements to avoid daily transfers of funds between the FCM's ~~30.7~~foreign futures separate accounts maintained in the United States and those maintained outside of the United States.

173 *Id.* §- 30.7(c).

174 *Id.* § 30.7(b).

175 *Id.* § 30.7(e)(1).

176 *Id.* § 30.7(e)(2).

such foreign futures customer,[177] (~~4~~5) requiring a calculation of the foreign futures and foreign options secured amount, and the maintenance of a residual interest in the separate account, in a manner similar to the calculation of the required segregated amount and residual interest applicable to futures customers,[178] and (~~5~~6) permitting investment of the amounts held in the separate account, subject to accepting liability for losses, in a manner similar to the manner in which FCMs may invest the funds held in the segregated account.[179]

~~Despite these parallels, however,~~ The current version of Part 30.7 and related provisions was adopted in 2013, as part of a significant revision to the CFTC ~~has~~framework for protection of customer funds generally.[180] These amendments were intended to align the protections accorded to foreign futures customers with those applicable to U.S. futures and cleared swaps.[181] As the adopting release noted,

> the proposed changes to § 30.7 were intended to provide a more coordinated approach to the regulations governing foreign futures and foreign options, with standards that are consistent with those for the futures and swaps markets. These regulations, including regulations governing how an FCM holds funds for customers trading on non-U.S. markets, would greatly enhance the protection of customer funds and avoid regulatory arbitrage. Such consistency would, to the extent practicable and appropriate, contribute to the goal of having customer property across futures, swaps and foreign futures markets be substantively similar.[182]

Before the CFTC adopted these extensive amendments, the Part 30 rules were significantly different from those governing customer funds for U.S. futures or cleared swaps, with respect to both the amount of funds required to be set aside and the legal status of those funds. In view of those differences, the CFTC concluded that the special account arrangement ~~is a~~, prior to the amendments, was more akin to a "security ~~arrangement, not~~ deposit" by the FCM for payment of its obligations to customers than to

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177 *Id.* § 30.7(f).

178 *Id.* § 30.7(g).

179 *Id.* § 30.7(h).

180 *See generally* CFTC, Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations, 78 Fed. Reg. 68506 (Nov. 14, 2013).

181 "Aligning the regulations, including regulations governing how an FCM holds funds for customers trading on non-U.S. markets with the requirements for customers trading on U.S. markets, will greatly enhance the protection of customer funds, and avoid competitive imbalances between trading on domestic and foreign contract markets that might result in regulatory arbitrage." *Id.* at 68,572.

182 *Id.* at 68,575.

a statutory trust of the type created by Section 4d(2) and the related CFTC regulations.[183] ~~Nonetheless,~~

As revised, the requirements of Rule 30.7 ~~prohibits the FCM from using the funds of one 30.7 customer to purchase, margin or settle the trades, contracts, or commodity options of~~appear to include all the elements of a "technical trust" in the same manner as the segregation rules applicable to U.S. futures and cleared swaps: defining the trust *res*, spelling out the trustee's fiduciary duties, and impose a trust prior to and without reference to any wrongdoing.[184] However, despite the stated intent of the amendments, the adopting release for these amendments did not explicitly refer to a statutory or technical trust, or ~~to secure or extend credit to, any person~~indicate that the CFTC intended to create a statutory trust over the customer funds held in a foreign futures secured account, and we have not identified any other ~~than~~ written guidance or interpretation by the CFTC or its staff expressly stating that such ~~30.7 customer~~statutory trust exists in this context, and to our knowledge, there have been no cases before a court in which the effectiveness of Rule 30.7 to create such a statutory or technical trust has been raised or determined. Because there is an element of judgment involved in determining whether any particular statutory or regulatory framework creates a technical trust, this lack of guidance makes it difficult to give definitive advice as to whether the new Rule 30.7 has this effect.[185]

The fact that Rule 30.7 is a regulation adopted by the CFTC, rather than a statute specifically enacted by Congress, should not affect the conclusion.[186] In *Grede* v. *FCStone, LLC*,[187] the court recognized *two* statutory trusts, the one created by the CEA for U.S. futures, and a second created by SEC regulations adopted under the Investment Advisers Act (the "*IAA*").[188] "Defendant's suggestion that the CEA trust trumps the IAA trust because it stems directly from a statutory provision is simply incorrect. . . . The IAA custody rule is a 'properly promulgated, substantive agency regulation' and thus has the same 'force and effect' as if it had been passed directly by Congress."[189] On appeal, the Seventh Circuit reversed the decision of the district court on other grounds and remanded

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183 *See* CFTC Div. of Trading & Mkts., Advisory No. 87-04, *Foreign Futures and Options. Compliance and Operational Questions and Answers.* (Nov. 18, 1987), at A.8 ("Moreover, as the secured amount is 'security' and not a 'trust' of funds explicitly denominated as belonging to customers, even absent special authorization, 'topping up' is not inconsistent with maintenance of the status of the account as separate."); *id.* at A. 9 ("Again the secured amount is a calculated amount of a required security deposit by the FCM to secure its obligations to customers, it is *not* customer money *per se* as are segregated funds.").

184 *See supra* Section VI.B, text accompanying notes 95-98.

185 ~~17 C.F.R. § 30.7(f) (2020).~~ *See, e.g.*, *In re Vito*, 598 B.R. 809 (Bankr. D. Md. 2019), which discusses the history of cases relating to the Maryland construction trust statute, under which courts have come down on both sides of the question as to the existence of a statutory trust.

186 485 B.R. 854, 872 (N.D. Ill. 2013), rev'd and remanded, 746 F.3d 244 (7th Cir. 2014).

187 *Id.*

188 *Id.* at 870.

189 *Id.*

the case for further action, but stated its agreement with the district court's analysis on the points discussed above.[190]

Courts have identified a number of factors that support the existence of a technical or statutory trust. Such a finding is likely, but not certain, if the relevant statute expressly designates funds received as "trust funds" and imposed specific duties on those disposing of the funds.[191] In both situations, unambiguous statutory language required performance of extensive, affirmative duties in managing the funds held in "trust" and clearly set forth the trust requirements.[192] An express reference to a "trust" is not required, but that "[t]he elements of a formal trust or typical attributes of such a trust must exist. The general characteristics of an express trust are sufficient words to create a trust, a definite subject, a certain object or res, with intent to create the trust relationship being a key element."[193] To demonstrate the existence of the intent to create a trust, some courts have pointed to statutory language requiring the purported trustee to hold the assets as "belonging to"[194] the customer, although the *Grede* court found such language to be unnecessary.[195]

Applying these factors to Rule 30.7, as amended by the 2013 CFTC Amendment, Rule 30.7 requires an FCM to "at all times maintain in a separate account or accounts money, securities and property in an amount at least sufficient to cover or satisfy all of its obligations to 30.7 customer," clearly identifying the *res* of the trust.[196] Rule 30.7(b) requires that the FCM "deposit the foreign futures or foreign options secured amount under an account name that clearly identifies the funds *as belonging to 30.7 customers*."[197] The purposes for which the funds contained in the foreign futures separate account may be used are clearly specified, and the funds are required to be held separately from funds available for any other purpose. Furthermore, as described above, Rule 30.7 requires "performance of extensive, affirmative duties in managing the funds

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190 *Grede v. FCStone*, 746 F.3d 244, 258–59 (7th Cir. 2014) ("Both the Segment 1 and Segment 3 funds were subject to statutory trusts. Segment 1 was protected by the Commodity Exchange Act and related CFTC regulations, while Segment 3 was protected by the Investment Advisors Act and related *259 SEC regulations. We agree with the district court that there is no legal basis for placing one trust ahead of the other, despite FCStone and the CFTC's attempts to argue otherwise. See *Grede*, 485 B.R. at 871–72. This bankruptcy therefore presented two equal pools of statutory trust claimants battling over an insufficient pool of commingled funds.")

191 *See, e.g.*, *In re Specialized Installers, Inc.*, 12 B.R. 546 (Bankr.D.Colo.1981) (Colorado Lien Trust Statute). Similarly, some courts have found that a technical trust exists where a statute did not refer to the funds as "trust funds" or to the creation of a trust, but specified the purpose of the funds to be segregated and provided for revocation of a license if the relevant funds were diverted for other purposes. *See Allen v. Romero*, 535 F.2d 618 (10th Cir.1976).

192 *In re Anzman*, 73 B.R. 156, 166 (Bankr. D. Colo. 1986).

193 *Id*. at 166–67 (citations omitted).

194 *In re Smith*, 72 B.R. 61, 63 (N.D. Iowa 1987).

195 *Grede*, 485 B.R. at 870 (N.D. Ill. 2013).

196 17 C.F.R. § 30.7(a).

197 *Id*. § 30.7(b). *See also* references to holding funds "on behalf of 30.7 customers" in Rule 30.7(c).

held in 'trust' and clearly set forth the trust requirements." Accordingly, there is a strong argument that Rule 30.7, like Section 4d of the CEA, creates a technical or statutory trust with respect to the foreign futures separate account. Whether or not a court were to agree with our conclusion, the FCM would be entitled to exercise its rights as a secured party with respect to the customer's account and the customer funds credited to the account.

VIII. STRUCTURE OF THE RELATIONSHIP AMONG PARTIES IN ~~SNCDS THAT ARE~~ PORTFOLIO-MARGINED SNCDS IN A 4D(F) ACCOUNT[198]

A. Background

Pursuant to Section 712(d)(1) of the Dodd-Frank Act, the CFTC and the SEC issued a joint release in August 2012 defining certain terms used in Title VII of the Dodd-Frank Act, including "swap" and "security-based swap."[199] Under that release, SNCDS, *i.e.*, CDS that are based on a single reference obligation or entity, are treated as security-based swaps under the second prong of the security-based swap definition, and therefore fall within the SEC's jurisdiction.[200] Any SNCDS that are triggered by an event relating to financial statements, financial condition or financial obligations of a single issuer of a security (such as a bankruptcy of an issuer, or a default on one of the issuer's debt securities or non-security loans) are also security-based swaps.[201] However, index

198 As discussed below, in the absence of CFTC/SEC exemptive orders, index CDS and SNCDS are subject to the CFTC's and SEC's jurisdictions, respectively, and are subject to their respective margining requirements. In the absence of exemptive orders from both the SEC and CFTC, the CFTC does not have jurisdiction over SNCDS and they cannot be held in a 4d(f) account. This memorandum does not address security-based swaps to the extent that they are not subject to a portfolio margining arrangement approved by the CFTC and the SEC.

199 *See* "Further Definition of 'Swap,' 'Security-Based Swap,' and 'Security-Based Swap Agreement'; Mixed Swaps; Security-Based Swap Agreement Recordkeeping," 77 Fed. Reg. 48,207 (Aug. 13, 2012) (to be codified at 17 C.F.R. pt. 1, 230, 240, 241) [*hereinafter* Swaps Release].

200 Subject to certain exceptions, the general definition of "security-based swap"" means "any agreement, contract, or transaction that (i) is a swap, as that term is defined under section 1a of the Commodity Exchange Act (without regard to paragraph (47)(B)(x) of such section); and (ii) is based on: (I) an index that is a narrow-based security index, including any interest therein or on the value thereof; (II) a single security or loan, including any interest therein or on the value thereof; or (III) the occurrence, nonoccurrence, or extent of the occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index, provided that such event directly affects the financial statements, financial condition, or financial obligations of the issuer." Securities Exchange Act of 1934 § 3(a)(69), 15 U.S.C. § 78c(a)(69) (2012). This memorandum addresses single-name CDS, but CDS based on a narrow index are also security-based swaps.

201 "The second prong of the statutory security-based swap definition includes a swap that is based on 'a single security or loan, including any interest therein or on the value thereof.' The Commissions believe that under this prong of the security-based swap definition, a single-name CDS that is based on a single reference obligation would be a security-based swap because it would be based on a single security or loan (or any interest therein or on the value thereof)." Swaps Release, at 48267.

CDS, which are CDS that are based on a broad-based index[202] of 10 or more securities (or other debt),[203] are swaps, and therefore subject to the CFTC's jurisdiction.[204] Thus, SNCDS and index CDS are subject to the SEC's and CFTC's jurisdictions, respectively.

Section 723[205] of the Dodd-Frank Act created CEA Section 2(h), which grants the CFTC authority to mandate swaps clearing; similarly, Section 763[206] added Section 3C to the Securities Exchange Act of 1934, as amended (the "*Exchange Act*"), which grants the SEC a similar mandate for security-based swaps clearing. On December 13, 2012, the CFTC adopted regulations to establish a clearing requirement under a new Section 2(h)(1)(A) of the CEA to require certain classes of SNCDS and interest rate swaps to be cleared by a DCO.[207] The SEC has not adopted any mandatory clearing requirements for security-based swaps thus far, although the deadline for registration by security-based swap dealers recently occurred.[208] As a result, index CDS are subject to the cleared swap requirements in the CEA and corresponding regulations, while SNCDS that constitute security-based swaps are not yet subject to a corresponding clearing requirement under the Exchange Act.

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202 AlthoughAs noted above, although we are only addressing single-name CDS here, note that thoseCDS based on narrow indices are also SBSs.security-based swaps. Only CDS based on broad-based indices are swaps.

203 Although the "10 or more" is a bright line standard that is commonly used, the definition of a broad-based security index is actually more nuanced. The CEA defines a narrow-based security index as an index of securities that meets one of the following four requirements: (1) it has nine or fewer components; (2) one component comprises more than 30 percent of the index weighting; (3) the five highest weighted components comprise more than 60 percent of the index weighting; or (4) the lowest weighted components comprising in the aggregate 25 percent of the index's weighting have an aggregate dollar value of average daily volume over a six-month period of less than $50 million ($30 million if there are at least 15 component securities). 7 U.S.C. § 1a(35) (2012). In turn, a broad-based security index is any index of securities that does not meet the legal definition of narrow-based security index. 17 C.F.R. § 41.1(c) (2020).

204 "An index CDS where the underlying reference is not a narrow-based security index or the issuers of securities in a narrow-based security index (*i.e.*, a broad-based index) is a swap." Swaps Release at 48273.

205 Commodity Exchange Act, Pub. L. No. 111-203, § 723, 124 Stat. 1675 (2010).

206 Commodity Exchange Act, Pub. L. No. 111-203, § 763, 124 Stat. 1762 (2010).

207 Clearing Requirement Determination Under Section 2(h) of the CEA, 77 Fed. Reg. 74,284 (Dec. 13, 2012) (to be codified at 17 C.F.R. pt. 39, 50) [*hereinafter* Clearing Requirement Release].

208 Recently, the SEC has taken steps towards "standing up" its security-based swap regime. *See, e.g.*, Cross-Border Application of Security-Based Swap Requirements, Exchange Act Release No. 34-87780, 85 Fed. Reg. 6,270 (Feb. 4, 2020) (to be codified at 17 C.F.R. pt. 201, 240). As the SEC's rules regarding the process for designating categories for mandatory security-based swaps clearing become effective, the SEC could begin designating categories of security-based swaps for mandatory clearing. *See* SEC, Order Granting Conditional Exemptions Under the Securities Exchange Act of 1934 in Connection With the Portfolio Margining of Cleared Swaps and Security-Based Swaps That Are Credit Default Swaps, 86 Fed. Reg. 61357, 61358 (Nov. 5, 2021).

B. Impact of CFTC/SEC Orders Permitting Portfolio Margining

Because the Dodd-Frank Act and the CFTC and SEC statutes and regulations implementing Dodd-Frank split jurisdiction over SNCDS between the two agencies, index CDS and SNCDS are subject to the varying requirements of the CFTC and SEC with respect to collateral, margin and other requirements for FCMs and broker-dealers, respectively. Distinct requirements also apply to DCOs and clearing agencies. In particular, in the absence of relief, the distinct requirements of Section 4d(a)(2), for swaps, and the Exchange Act, for security-based swaps, and the specific account segregation requirements for these two categories of instruments, a program could not be established to commingle and portfolio margin cleared customer portfolios of SNCDS where the portfolio includes both security-based swaps and swaps (a "*SNCDS portfolio*"). As a result, any person dually registered as a broker-dealer under the Exchange Act and an FCM under the CEA (a "*BD/FCM*") would be required to separately hold and margin index CDS and SNCDS, even if these trades are cleared through the same DCO. Moreover, because BD/FCMs could not commingle or margin across a SNCDS portfolio, customers would be required to pay full margin on their index CDS and their SNCDS positions without reflecting any offsetting positions, instead of offsetting across the SNCDS portfolio.

Both the CFTC and the SEC regulations and the Dodd-Frank Act itself appear to contemplate not only the existence of portfolio margining, but also the view that portfolio margining with respect to these instruments would be beneficial and promote sound risk management. Section 713 of the Dodd-Frank Act sets forth changes to the CEA to provide for portfolio margining; these changes are codified in Section 20(c) of the CEA.[209] In the adopting release for the CFTC's mandatory clearing regulations, the CFTC notes that, "[g]iven that the single-name reference entities will likely also be constituents of a given index within a portfolio, the Commission believes

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[209] Dodd-Frank Section 713 created new subsection (h) to Section 4(d) of the CEA, which states that "[n]otwithstanding subsection (a)(2) or the rules and regulations thereunder, and pursuant to an exemption granted by the Commission under section 4(c) of this Act or pursuant to a rule or regulation, a futures commission merchant that is registered pursuant to section 4f(a)(1) of this Act and also registered as a broker or dealer pursuant to section 15(b)(1) of the Securities Exchange Act of 1934 may, pursuant to a portfolio margining program approved by the Securities and Exchange Commission pursuant to section 19(b) of the Securities Exchange Act of 1934, hold in a portfolio margining account carried as a securities account subject to section 15(c)(3) of the Securities Exchange Act of 1934 and the rules and regulations thereunder, a contract for the purchase or sale of a commodity for future delivery or an option on such a contract, and any money, securities or other property received from a customer to margin, guarantee or secure such a contract, or accruing to a customer as the result of such a contract. The Commission shall consult with the Securities and Exchange Commission to adopt rules to ensure that such transactions and accounts are subject to comparable requirements to the extent practical for similar products." Commodity Exchange Act, Pub. L. No. 111-203, § 713(b), 124 Stat. 1646, 1647 (2010). In addition, Section 20(c) of the CEA states that "The Commission shall exercise its authority to ensure that securities held in a portfolio margining account carried as a futures account are customer property and the owners of those accounts are customers for the purposes of subchapter IV of chapter 7 of Title 11." 7 U.S.C. § 24(c) (2012).

that such portfolio margining initiatives are consistent with the sound risk management policies for DCOs that are required under 39.13(g)(4)."[210] Similarly, as discussed below, in announcing its 2012 relief permitting portfolio margining, the SEC has stated that these programs are in the public interest "because it would promote a more accurate measure of the risk of the total position of the customer based on off-setting positions."[211]

In 2011, the CFTC and SEC granted approval to ICE Clear Credit to offer portfolio margining for clearing members' proprietary positions in index CDS and SNCDS, but this approval did not extend to positions held for customers of clearing members.[212] Subsequently, on December 14, 2012, the SEC issued an exemptive order (the "*2012 SEC Exemptive Order*")[213] granting entities registered with both the CFTC and SEC the ability to comply with certain requirements applicable to the maintenance of customer accounts under the CEA without complying with parallel requirements under the Exchange Act in order to permit clearing organizations and their clearing members to offer programs that provide for commingling and portfolio margining of cleared customer SNCDS portfolios ("*SNCDS margining programs*"). The SEC notes in the 2012 SEC Exemptive Order that:

> [a]fter careful consideration, the Commission believes that providing certain conditional exemptive relief to facilitate portfolio margining … is necessary or appropriate in the public interest, and is consistent with the protection of investors, because it would promote a more accurate measure of the risk of the total position of the customer based on off-setting positions. Moreover, the conditions to the exemption will provide restrictions designed to protect money, securities and property of a security-based swap customer, to address certain differences in the statutory requirements of the Exchange Act and CEA, and to promote appropriate risk management and disclosure.[214]

As the framework governing security-based swaps reaches completion and effectiveness, the SEC has issued an updated exemptive order (the 2021 SEC Exemptive Order), eliminating some aspects of the relief that will no longer be necessary to entities that comply with the SEC's regulations. The 2021 SEC Exemptive Order supersedes and

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210 Clearing Requirement Release, *supra* note 207 at 74,293.

211 Order Granting Conditional Exemptions under the Securities Exchange Act of 1934 in connection with Portfolio Margining of Swaps and Security-Based Swaps, Exchange Act Release No. 34-68433, 77 Fed. Reg. 75,211, 75,214 (Dec. 19, 2012) [hereinafter 2012 SEC Exemptive Order].

212 Self-Regulatory Organizations; ICE Clear Credit LLC; Order Approving Proposed Rule Change to Adopt ICC's Enhanced Margin Methodology, Exchange Act Release No. 34-66001, 76 Fed. Reg. 79,729, 79,730 (Dec. 22, 2011).

213 2012 SEC Exemptive Order, *supra* note 211.

214 *Id.* at 75,214.

replaces the 2012 SEC Exemptive Order. This updated order was issued and became effective on November 1, 2021.[215]

To permit SNCDS margining programs, the 2021 SEC Exemptive Order provides conditional relief from otherwise applicable restrictions related to customer accounts under the Exchange Act to (i) persons dually registered as a clearing agency under the Exchange Act and a DCO under the CEA (a "*clearing agency/DCO*~~"),~~"), and (ii) BD/FCMs. Subject to a number of conditions, the relief permits dual registrants to comply with certain requirements related to segregation and margining of customer accounts under the CEA in lieu of parallel requirements under the Exchange Act.

The 2021 SEC Exemptive Order exempts a clearing agency/DCO from restrictions concerning segregation, investment and use of customer collateral for security-based swap positions under Sections 3E(b), (d), and (e) of the Exchange Act and related rules to the extent that it is performing the functions of a clearing agency for a customer participating in a SNCDS margining program. This relief is only available to accounts of customers that are eligible contract participants, as defined in Section- 1a(18) of the CEA and further defined in the Swaps Release. To qualify for relief under the 2021 SEC Exemptive Order, the clearing agency/DCO must ~~undertake certain actions aimed at providing its BD/FCM clearing members with a choice as between offering customers the protections afforded under the Exchange Act and the protections afforded under the CEA. In addition, the clearing agency/DCO must take all necessary action within its control to~~ obtain any other relief ~~needed~~, and ~~establish~~have appropriate rules and operational practices, needed to permit its members that are BD/FCMs to maintain ~~collateral~~the money, securities and property received by the BD/FCM from its cleared swaps customers or affiliates (as defined in the order) to margin ~~a customer's cleared~~an SNCDS portfolio in a segregated account established and maintained in accordance with Section ~~3E of the Exchange Act and any rules thereunder for purposes of clearing such customer positions under a margining program and to provide (at the BD/FCM's election) a SNCDS margining program with respect to customer collateral received to margin positions in a cleared SNCDS portfolio in a segregated account established and maintained in accordance with Section~~ 4d(f) of the CEA and the related rules ~~thereunder~~ for the purpose of clearing such customer positions under a SNCDS margining program.

For BD/FCMs, the 2021 SEC Exemptive Order provides relief to a BD/FCM from the requirements of Exchange Act Sections 3E(b), (d), and (e), and Section- 15(c)(3) and Rule 15c3-3 thereunder and any requirement to treat an affiliate[216] as a customer for purposes of Exchange Act Rules 8c-1 and 15c2-1 to permit the BD/FCM to margin customer positions in security-based swaps included in a segregated account established and maintained in accordance with Section- 4d(f) of the CEA under a SNCDS margining program. To qualify for this relief, the BD/FCM must meet certain conditions. ~~Notably, the~~The BD/FCM must ~~require minimum margin levels with respect~~

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215 *See* 2021 SEC Exemptive Order, *supra* note 37.

216 For these purposes, an "affiliate" of a BD/FCM would include a person that (directly or indirectly) controls, is controlled by, or is under common control with the BD/FCM.

~~to any customer transaction participating in the SNCDS margining~~have adopted an internal risk management program ~~at least equal to the amount determined using a margin methodology established~~that is reasonably designed to identify, measure, and ~~maintained by the BD/FCM~~manage the risks arising from its program to allow cleared swaps customers and affiliates to commingle and portfolio margin CDS that has been approved in advance by the ~~SEC~~Commission or ~~SEC~~the Commission staff~~, who will review~~ and meets the standards in ~~consultation with the CFTC and the Financial Industry Regulatory Authority ("*FINRA*").~~paragraph (c) of this order. The BD/FCM must be in compliance with applicable laws and regulations relating to risk management, capital, and liquidity, ~~as well as~~and with applicable clearing agency/DCO rules and CFTC requirements (including segregation and related books and records provisions) for accounts established and maintained in accordance with Section 4d(f) of the CEA and related rules ~~thereunder, and participation is limited to~~ (in the case of cleared swaps customers ~~that qualify as eligible contract participants.~~) and for cleared swaps proprietary accounts (in the case of affiliates), and subject to an SNCDS margining program. In addition, before receiving any collateral from a customer or affiliate to margin its positions in a cleared SNCDS portfolio participating in a SNCDS margining program, the BD/FCM must furnish to the customer a disclosure document containing the following information: (i) a statement indicating that the customer's collateral will be held in an account maintained in accordance with the segregation requirements of Section 4d(f) of the CEA and that the customer has elected to seek protections under Subchapter IV of Chapter 7 of Title 11 of the U.S.C. and the rules and regulations thereunder with respect to such collateral; and (ii) a statement that the broker-dealer segregation requirements of Section 15(c)(3) and Section 3E of the Exchange Act and the rules thereunder, and any customer ~~protections~~property under the SIPA and the stockbroker liquidation provisions, will not apply to such collateral.[~~217~~] The SEC noted that this disclosure requirement is "essential to highlight to customers who elect to participate [in a SNCDS margining program] maintained in accordance with Section 4d(f) of the CEA that the account will be governed by the segregation requirements under the CFTC's regulatory regime and that any protections under the SIPA will not be available to the account in the event of insolvency."[218] With respect to affiliates, the BD/FCM must maintain the margin provided by the affiliate in a cleared swaps proprietary account, and enter into a similar nonconforming subordination agreement.

The 2021 SEC Exemptive Order includes additional conditions for a BD/FCM to obtain relief that are specific to affiliate accounts and third-party customer accounts. With respect to a customer that is not an affiliate of the BD/FCM, (i) the BD/FCM must maintain collateral received to margin the customer's positions in a cleared SNCDS portfolio ~~positions in a~~ participating in a SNCDS margining program in a segregated account established and maintained in accordance with Section 4d(f) of the CEA and the rules thereunder for the purpose of clearing such customer positions under a

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~~217 SEC Exemptive Order, *supra* note 142 at 75,217.~~

218 ~~*Id.*~~*See* 2012 SEC Exemptive Order, *supra* note 211, at 75,219.

SNCDS margining program; and (ii) the BD/FCM must enter into a non-conforming subordination agreement with each customer.[219] The subordination agreement must contain a specific acknowledgment by the customer that its collateral will not receive customer treatment under the Exchange Act or SIPA or be treated as customer property as defined in 11 U.S.C. § 741 in a liquidation of the BD/FCM, and that such collateral will be subject to any applicable protections under Subchapter IV of Chapter 7 of Title 11 of the U.S.C. and the rules and regulations thereunder; as well as an affirmation by the customer that all of its claims with respect to such collateral against the BD/FCM will be subordinated to the claims of other securities customers and security-based swap customers not operating under a SNCDS margining program.

The CFTC issued a similar order on January 14, 2013 (the "*CFTC ICE Clear Credit Order*"),[220] which allowed ICE Clear Credit and its dually registered clearing members to hold customer property in a cleared swaps account subject to Section 4d(f) of the CEA to margin, guarantee or secure both cleared ~~swap contracts~~swaps and cleared security-based swaps and to provide for portfolio margining of such cleared ~~swap contracts~~swaps and cleared security-based swap contracts, and allowed ICE Clear Credit to benefit from the 2012 SEC Exemptive Order.[221] Since then, a number of firms have had their internal risk models approved by the SEC, through

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219 The term "non-conforming subordination agreement" is used to refer to a subordination agreement between a BD/FCM and its customer regarding all customer money, securities or property held in a segregated account maintained in accordance with CEA Section 4d(f), in the case of a customer that is not an affiliate of the BD/FCM, or in a proprietary account of the BD/FCM, in the case of a customer that is an affiliate of the BD/FCM, where the customer agrees to subordinate all its claims against the BD/FCM with respect to such money, securities and property that it furnishes to the BD/FCM as collateral in respect of the cleared security-based swap contracts to the claims of all securities customers and security-based swaps customers not operating under the portfolio margining program. Such subordination is intended to help provide the customer with clarity that the segregation requirements of the Securities Exchange Act and any protections of SIPA and the stockbroker liquidation provisions will not apply to the customer's cleared security-based swap contracts under the portfolio margining program (and will instead be subject to the segregation requirements and customer protections afforded under the CEA and CFTC regulations).

220 CFTC, Treatment of Funds Held in Connection with Clearing by ICE Clear Credit of Credit Default Swaps (Jan. 14, 2013), *available at* https://www.cftc.gov/sites/default/files/idc/groups/public/@newsroom/documents/file/icecreditclearorder011413.pdf.

221 On April 9, 2013, the CFTC issued a similar order permitting ICE Clear Europe to hold security-based swaps, including CDS, in a 4d(f) account, effectively allowing ICE Clear Europe to offer CDS portfolio margining as well. CFTC, Treatment of Funds Held in Connection with Clearing by ICE Clear Europe of Credit Default Swaps (Apr. 9, 2013), *available at* https://www.cftc.gov/sites/default/files/stellent/groups/public/@requestsandactions/documents/ifdocs/iceclearеurope4dfcds040913.pdf. Most recently, the CFTC issued a similar order with respect to LCH SA. *See* CFTC, Treatment of Funds Held in Connection with Clearing by LCH SA of Single-Name Credit Default Swaps, Including Spun-Out Component Transactions (Nov. 1, 2021), *available at* https://www.cftc.gov/PressRoom/PressReleases/8458-21.

authority delegated to FINRA, and now use 4d(f) accounts to offer SNCDS margining programs to customers.[222]

In addition, FINRA Rule 4240 sets margin requirements for SNCDS and establishes an interim pilot program with respect to margin requirements for transactions in SNCDS. The rule was initially enacted prior to the Dodd-Frank Act, in 2009, and has been amended several times since then. Most recently, on May 31, 2019, FINRA filed notice of a proposed rule change with the SEC to extend the implementation of the pilot program to July 20, 2020 with respect to margin requirements for certain transactions in security-based SNCDS.[223]

C. Characteristics of Principal to Agent Relationship

By including security-based swaps in the statutory framework established by Section 4d(f) of the CEA,[224] the portfolio margining relief causes the FCM-customer relationship with respect to these contracts to follow the framework described in Section I above, including the status of the BD/FCM as agent-trustee with respect to the security-based swaps cleared in this capacity and the application of the statutory trust to the security-based swaps themselves and any related margin. Accordingly, an FCM's relationship with its customers with respect to ~~portfolio-margined~~Portfolio-Margined SNCDS, and the actions it takes with respect to such ~~portfolio-margined~~Portfolio-Margined SNCDS, is no different than the relationship with respect to any other swap contracts cleared or carried by the FCM on behalf of its customers.

The CFTC's statutory authority with respect to portfolio margining, as codified in CEA Section 20(c), addresses only "*securities* held in a portfolio margining account carried as a *futures* account."[225] On November 6, 2013, the CFTC implemented new rules to implement certain statutory provisions of the Dodd-Frank Act, including

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222 On January 31, 2014, eight firms — Goldman, Sachs & Co., Morgan Stanley & Co. LLC, UBS Securities LLC, Barclays Capital Inc., J.P. Morgan Securities LLC, Credit Suisse Securities (USA) LLC, Citigroup Global Markets Inc., and Deutsche Bank Securities, Inc. — received letters from the SEC Division of Trading and Markets approving their margin methodologies in connection with their applications for authority to offer CDS Margining Programs. *See, e.g.*, SEC, Temporary Conditional Approval Letter to J.P. Morgan Securities LLC on CDS Portfolio Margin Program (Jan. 31, 2014), *available at* https://www.sec.gov/rules/exorders/2014/34-68433-jpm-013114.pdf.

223 Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing and Immediate Effectiveness of a Proposed Rule Change to Extend the Implementation of FINRA Rule 4240 (Margin Requirements for Credit Default Swaps), Exchange Act Release No. 34-85981, 84 Fed. Reg. 26,486 (June 6, 2019). For more information, *see SR-FINRA-2019-16, Proposed Rule Change to Extend the Implementation of FINRA Rule 4240 (Margin Requirements for Credit Default Swaps)*, FINRA, *available at* https://www.finra.org/rules-guidance/rule-filings/sr-finra-2019-016.

224 Commodity Exchange Act, Pub. L. No. 111-203, § 724, 124 Stat. 1682 (2010). Section 724(b) also addresses bankruptcy treatment of cleared swaps. § 724(b), 124 Stat. at 1684.

225 7 U.S.C. § 24(c) (2012) (emphasis added).

with respect to securities held in a portfolio margining account. The new rules are technical in nature, designed to clarify the CFTC's position that "Congress, in directing the [CFTC] to clarify the treatment of 'securities' held in a 'futures account,' did not mean to imply that securities held in a Cleared Swaps Customer Account would not be treated as customer property."[226] The definition of customer in Part 190 was revised to include ~~that "[t]o the extent not otherwise included, customer shall include the~~ "the owner of a portfolio cross-margining account covering commodity contracts and related positions in securities (as defined in section 3 of the Exchange Act) that is carried as a futures account or cleared swaps customer account."[227] Similarly, the scope of customer property in Part 190 now clarifies, as a result of this rule change, that "[c]ustomer property includes … [~~t]o the extent not otherwise included, securities~~s]ecurities held in a portfolio margining account carried as a futures account or a cleared swaps customer account."[228] These provisions demonstrate the CFTC's affirmative decisions to treat customers whose securities are portfolio-margined in accounts with FCMs as "customers" for the purpose of subchapter IV of chapter 7 of the Bankruptcy Code.[229]

IX. CONTRACTUAL ARRANGEMENT BETWEEN COUNTERPARTY AND UNCLEARED SWAPS AFFILIATE

It may be the case that, in addition to entering into cleared ~~swap contracts~~swaps that are carried by an FCM, a customer may also enter into bilateral uncleared swaps with counterparties. By definition, uncleared swaps are not cleared through a DCO or other clearing organization, and FCMs do not carry their customers' uncleared ~~swap~~swaps positions. However, the customer may be a party to uncleared swaps with an affiliate of the FCM (*i.e.*, an "*uncleared swaps affiliate*~~")~~") (which would be a registered or exempt swap dealer) and may therefore conduct both cleared and uncleared swaps with affiliated entities. A customer that wants to enter into an uncleared swap with an uncleared swaps affiliate will do so on a bilateral, principal-to-principal basis; that is, the uncleared swaps affiliate will act as the direct contractual counterparty to the customer in the uncleared swap, in contrast to cleared ~~customer transactions~~swaps, in which the FCM serves as the customer's agent, clears the transaction through a DCO,

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226 Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy, 78 Fed. Reg. 66,621, 66,~~631~~630 (Nov. 6, 2013) (to be codified at 17 C.F.R. pt. 23, 190).

227 17 C.F.R. §- 190.01~~(l)~~ (2020).

228 *Id.* §- 190.08(a)(1)(i)(~~F~~G).

229 Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy, 78 Fed. Reg. at 66,621. The revisions cited above were suggested in comments on the notice of proposed rulemaking by ICE, and were implemented by the CFTC "to avoid the implication that portfolio margining arrangements involving swaps do not receive the same bankruptcy protection as portfolio margining arrangements involving futures," further supporting the argument that Section 4d(f) accounts should be viewed similarly to Section 4d(a)(2) accounts in this context. *Id.* at 66,~~631~~630.

and carries the transaction between the FCM and the DCO as the customer's agent and intermediary.

The relationship between the customer and the uncleared swaps affiliate is typically governed by an agreement, such as an ISDA Master Agreement, which often includes supplementary schedules, confirmations or documentation (the "*uncleared swaps agreement*~~").~~"). This uncleared swaps agreement is wholly separate from the customer agreement between the customer and the affiliated FCM and differs from a customer agreement in key respects, including that the agreement establishes a bilateral contractual relationship between the customer and the uncleared swaps affiliate as principals[230] and that the applicable regulatory regimes impose different requirements with respect to such matters as the initial margin and variation margin that the parties to the contract are required to deliver.[231]

The margin requirements applicable to uncleared swaps differ ~~from those applicable to cleared swap contracts~~ in nature, amount and procedural requirements~~.~~ from those applicable to cleared swaps. Initial margin, in both cleared ~~customer transactions~~swaps and uncleared swaps, serves as security for the future performance of the applicable party. However, variation margin in the context of ~~a~~ cleared ~~customer transaction~~swaps is a settlement payment,[232] but ~~also~~ constitutes *collateral* for the relevant party's obligations~~,~~ in the context of an uncleared swap.[233] Moreover, segregation of the customer's margin is not necessarily required in connection with uncleared swaps; segregation is an elective choice of the counterparty, and if required by the customer means that the customer's initial margin will be held in a separate custodial account – but no special statutory trust is established. The types of margin permitted ~~in~~to be used to secure an uncleared swap is limited, particularly in the context of variation margin ~~in~~; uncleared swap affiliates will generally be swap dealers or major swap counterparties, which ~~a swap entity is~~are permitted to post or collect as variation margin to or from a counterparty ~~that is a swap entity~~ only immediately available cash funds.[234] These requirements are applied pursuant to the uncleared swaps margin rules adopted by the federal banking regulators (the "*prudential regulators*~~")~~") for uncleared swaps

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230 *See 2002 ISDA Master Agreement*, § 3(g), INT'L SWAPS AND DERIVATIVES ASS'N, INC. (representing that each party is entering into the agreement "as principal and not as agent of any person or entity").

231 *See id.* § 6(e). For close-out netting under Section 6(e) to be enforceable, the parties must have entered into the agreement as principals and not as agents of a third party.

232 *See* John C. Lawton, CFTC Interpretive Letter, ~~CFTCLTR~~CFTC LTR No. 17-51, 2017 WL 4641494 (Oct. 12, 2017), *available at* https://www.cftc.gov/csl/17-51/download.

233 17 C.F.R. § 23.151 (2020) ("Variation margin means the collateral provided by a party to its counterparty to meet the performance of its obligation under one or more uncleared swaps between the parties as a result of a change in value of such obligations since the trade was executed or the last time such collateral was provided~~."); *see also supra* note 162.~~.").

234 ~~*Id.* §~~ *See, e.g., id.* § 23.156(b)(1)(i).

affiliates that are banking entities[235] or by the CFTC for other types of uncleared swaps affiliates.[236]

Most ~~typically, an~~ uncleared swaps ~~agreement is~~agreements are based on an ISDA Master Agreement (an "*ISDA Master Agreement*~~").~~"). The ISDA Master Agreement sets forth the terms of the bilateral agreement between a customer and an uncleared swaps affiliate to enter into individual uncleared swaps in an agreed-upon form that provides industry-standard legal protections to the parties. Many ISDA Master Agreements implement the margin requirements applicable to uncleared swaps by incorporating the ISDA Credit Support Annex, which governs the provision of margin in connection with the related uncleared swaps.[237] In the ISDA Credit Support Annex, the customer and uncleared swaps affiliate each pledge to the other party a first priority security interest in, lien on and setoff right on collateral transferred in connection with the uncleared swaps as security for their respective contractual obligations. These agreements may be amended specifically to comply with the margin requirements applicable to uncleared swaps or may incorporate the ISDA 2016 Variation Margin Protocol, which amends agreements that were in place before the margin rules took effect.

In many cases, a customer will grant to the uncleared swaps affiliate a security interest in the customer's rights against, and assets held or carried by, the FCM that is affiliated with the uncleared swaps affiliate, including the customer's contractual rights, customer account, and other customer property carried in the customer account. These arrangements may be implemented in a number of ways, including by means of a tri-party agreement among the customer, the FCM and the uncleared swaps affiliate or by the customer entering into separate agreements with the FCM and the uncleared swaps affiliate or incorporating the relevant provisions into its primary agreement with each entity. This memorandum refers to whichever agreement or agreements that contain the provision granting the security interest to the uncleared swaps affiliate as the "*cross-affiliate agreement*." In either case, the cross-affiliate agreement provides the uncleared swaps affiliate with rights and remedies on a cross-product and cross-affiliate basis with respect to customer transactions and uncleared swaps entered into by the customer.

Typically, the uncleared swaps agreement specifies a number of events of default, many of which will also constitute events of default under the customer

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235 The "prudential regulators" are the OCC, the Federal Reserve Board, the FDIC, the Farm Credit Administration, and the Federal Housing Finance Agency. *See* 7 U.S.C. §- 1a(39) (2012).

236 Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74,839 (Nov. 30, 2015) (to be codified at 12 C.F.R. pt. 45, 237, 349, 624, 1221); Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 635 (Jan. 6, 2016) (to be codified at 17 C.F.R. pt. 23, 140); Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants-Cross-Border Application of the Margin Requirements, 81 Fed. Reg. 34,817 (May 31, 2016) (to be codified at 17 C.F.R. pt. 23).

237 Although an ISDA Credit Support Annex is not required, this memorandum assumes, as is typically the case, that an uncleared swaps agreement is in the form of an ISDA Master Agreement and contains an ISDA Credit Support Annex.

agreement, typically including bankruptcy, non-payment and breach of representations. Upon the occurrence of an event of default, the uncleared swaps affiliate may (i) close out, liquidate or otherwise terminate any uncleared swaps, (ii) foreclose upon any margin pledged to the uncleared swaps affiliate, (iii) seek payment of any deficit by the customer or its estate, and (iv) pay any balance over to the customer or its estate or apply the balance to other obligations of the customer, as the case may be. If the uncleared swaps agreement includes, as an event of default, a default under the customer agreement, these rights would be available to the uncleared swaps affiliate upon the occurrence of an event constituting a default under the customer agreement.[238]

X. SECURITY INTERESTS IN CUSTOMER TRANSACTIONS, ACCOUNTS AND MARGIN

FCMs generally require their customers to grant to the FCM a security interest in the customer's ~~customer~~ account[239] and all the assets credited to that account, including the customer transactions carried for the customer. Although the security interest does not necessarily provide the basis on which an FCM may exercise its rights to liquidate a customer's ~~customer~~ transactions or liquidate and apply the customer's margin, as discussed in Section XI.B, maintaining a fully perfected security interest may be of importance for a number of reasons, as discussed more fully in Section X.B.1. FCMs have traditionally been understood to have a broker's lien in the assets they carry for their customers, whether or not the customer agreement explicitly provides for such a lien,[240] and most customer agreements – particularly those that provide for clearing and carrying of cleared ~~swap contracts~~swaps – now typically include an explicit grant to the

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238 We recognize that it is possible—though it would be unusual—for the FCM or the uncleared swaps affiliate, as the case may be, to elect not to use its cross-affiliate default right. For purposes of this memorandum, we assume that, upon the event of default at either entity, both entities will declare a default.

239 To be clear, the customer grants a security interest in the customer account maintained on the books of the FCM, including the customer's beneficial interest in positions held in the FCM's omnibus customer account for the benefit of the customer. The customer does not grant a security interest in the accounts in which the FCM deposits the customer's funds, which are either segregated omnibus accounts maintained by the FCM with its bank in the name of the FCM for the benefit of its customers in the relevant CFTC account class (*i.e.*, U.S. futures and options, foreign futures and options and swaps) or the FCM's account with a DCO.

240 *See* American Bar Association, Section of Business Law, Interim Report of the Advisory Committee on Settlement of Market Transactions 3 (Draft of July 31, 1991).

The terms of a customer agreement typically grant the FCM broad rights to repledge, rehypothecate or dispose of the customer's margin in the form of securities (although that right is subject to "applicable law," including the customer property rules, which require the FCM to segregate or set aside any proceeds from rehypothecating or disposing of the securities). Additionally, the U.S. futures customer property rules specify that in the daily computing of the amount of U.S. futures customer funds required to be in held segregated accounts, the FCM may offset any net deficit in the customer's account against the current market value of readily marketable securities, less applicable haircuts, held for that account. However, as a condition to doing so, the FCM must maintain a security interest in the securities "including a written authorization to liquidate the securities at the [FCM's] discretion." 17 C.F.R. § 1.32(b).

FCM of a security interest in the customer's account and the customer transactions and other assets that are carried in the customer account.

Security interests may also be important when a customer engages in transactions that fall within more than one account class. In these cases, the relationship among a financial institution, its affiliates and a customer may involve both customer transactions and foreign futures, and both cleared and uncleared ~~customer~~ transactions, and may include relationships between both the FCM and the customer and an affiliate of the FCM and the customer. When a customer engages an FCM to clear and carry customer transactions for it, and at the same time is a party to uncleared swaps with an affiliate of the FCM, the uncleared swaps affiliate may take a security interest in the customer transactions carried in the customer's account with the FCM, and the related margin, subject to the FCM's rights in those assets. At the same time, an FCM may take a security interest in the uncleared swaps that the customer enters into with the FCM's uncleared swaps affiliate, and related collateral or margin, to provide further protection in the event of the customer's default, even though second liens on these types of assets will not satisfy margin requirements under the CEA.

Accordingly, this section analyzes the measures required to perfect a security interest in customer transactions, customer accounts and customer margin. As an initial matter, Section X.A below identifies the circumstances in which perfection of a security interest will be governed by New York law (insofar as New York law is concerned).[241] Section X.B then addresses the method by which perfection may be achieved under New York law.

In both cases, the analysis depends on whether the property in question consists of:

(1) rights under customer transactions (*i.e.*, U.S. futures ~~contracts~~, cleared ~~swap contracts~~swaps and foreign futures ~~contracts~~);

(2) rights under uncleared swaps;

(3) margin consisting of securities; and

(4) margin consisting of funds on deposit with a depositary institution ("*cash*").

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241 Depending on the law in the jurisdiction in which the customer is located, it may be prudent to address perfection of the security interest under one or more other jurisdictions as well. This memorandum does not address when perfection of the security interest under the laws of any jurisdiction other than New York would be beneficial or advisable, or the method by which any such perfection would be achieved.

As discussed below, both the analysis of the law that governs perfection of the security interest, and the method of perfection, differs for each of these types of property.

A. When New York Law Applies

This memorandum addresses the perfection of security interests under New York law. Whether New York law will apply to the perfection of a security interest in any collateral, including customer transactions, customer accounts and margin, will be determined by both the Uniform Commercial Code, as in effect in the State of New York (the "*UCC*~~"),~~"), and by the Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary (the "*Hague Convention*~~").~~").[242]

1. Creation and Attachment of the Security Interest

The security interest of an FCM in the customer transactions and the other property that it carries for a customer is typically established by the customer agreement.[243] The security interest of an uncleared swaps affiliate of an FCM in customer transactions and customer property carried by the FCM is typically established by the security agreement forming a part of the uncleared swaps agreement. If the FCM takes a security interest in the uncleared swaps between the customer and the uncleared swaps affiliate, that security interest may be established by the customer agreement or by an ancillary security agreement between the customer and the FCM. As noted above, we have assumed that each customer agreement and uncleared swaps agreement, including any related security agreement, is governed by New York law.

The UCC provides that the parties to a transaction that bears a reasonable relation both to New York and to another jurisdiction may agree that the laws either of New York or of the other jurisdiction will govern their rights and duties in relation to the transaction, except that the parties do not have the right to choose the law governing certain matters.[244] In addition, under Section- 5-1401 of the New York General

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242 Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary, July 5, 2006, 46 I.L.M. 649 [hereinafter Hague Convention].

243 ~~U.C.C~~N.Y. UCC. § 9-201(a) (2012) ("General effectiveness. Except as otherwise provided in this chapter, a security agreement is effective according to its terms between the parties, against purchasers of the collateral, and against creditors."). In some cases, an FCM may also enter into additional agreements creating a security interest, where it deems it necessary or advisable in view of the circumstances applicable to a particular customer or type of customer.

244 *Id.* § 1-301(a). The relevant exceptions to this rule relate to the determination of the law governing the perfection, the effect of perfection or non-perfection, and the priority of a security interest, and to the determination of a ~~security~~securities intermediary's jurisdiction, both of which are addressed below.- The mandatory choice of law provisions of Article 8 and Article 9 of the New York UCC specify the law governing perfection, the effect of perfection or non-perfection, or priority of security interests, the assertion of adverse claims with respect to securities and security entitlements, and certain other matters involving issuers and securities intermediaries. -*Id.* § 1-301(c).

Obligations Law, the parties to any agreement, contingent or otherwise, relating to a transaction covering $250,000 or more in the aggregate may agree that the law of the State of New York will govern their rights and duties in whole or in part under the agreement.[245] As noted above, we have assumed that each customer is stated to be governed by New York law, and that the aggregate amount of the transactions covered by each customer agreement is $250,000 or more. While we have not identified any cases in which the question has been specifically addressed, we believe that the appropriate measure of the value of transactions for purposes of applying this statutory test is the aggregate value of the transactions between the FCM and the customer over the life of the customer agreement.[246]

However, even if the choice of New York law is honored by a New York court, New York courts have found that "a contract that is illegal in its place of performance is unenforceable in New York if the parties entered into the contract with a view to violate the laws of that other jurisdiction."[247] Even if a contract may be legally performed under New York law, the contract may not be enforceable under New York law if a party knew that the contract was illegal under the laws of the jurisdiction of performance or was deliberately ignorant of that fact.[248] As noted above, we have assumed that performance by each party of its obligations under each customer transaction and any agreement relating to any customer transaction, including the customer agreement, will comply with applicable law and with any requirement or restriction imposed by any court or government body having jurisdiction over such party and will not result in a default under or breach of any agreement or instrument then binding upon such party.

Accordingly, on the basis of the assumptions set forth above, we believe that a New York court would recognize the choice of New York law to govern the customer agreement and any related security agreement that is governed by New York law.

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245 N.Y. GEN. OBLIG. LAW §- 5-1401 (McKinney 2020).

246 *See Cambridge Nutrition A.G.* v. *Fotheringham*, 840 F. Supp. 299 (S.D.N.Y. 1994). The *Cambridge Nutrition* court held that the choice of New York law and the forum selection clause were binding under N.Y. General Obligations Law §§- 5-1401 and 5-1402 because the aggregate value of the contract exceeded $1 million although the amount in dispute was only $10,000. *Id.* at 301. For purposes of the analysis in this opinion, the transactions whose value would be considered for purposes of determining whether there is an agreement relating to a transaction covering $250,000 or more would be the customer transactions executed under the agreement and any other transactions executed under the same agreement (*e.g.*, margin advances, fees, etc.).

247 *Lehman Bros. Commercial Corp.* v. *Minmetals Intern. Non-Ferrous Metals Trading Co.*, 179 F. Supp. 2d 118, 138 (S.D.N.Y. 2000) (citing *Rutkin* v. *Reinfeld*, 229 F.2d 248, 255-56 (2d Cir. 1956); *Dornberger* v. *Metropolitan Life Ins. Co.*, 961 F. Supp. 506, 533-35 (S.D.N.Y. 1997); *Hesslein* v. *Matzner*, 19 N.Y.S.2d 462, 463-64 (N.Y. City Ct. 1940)).

248 *See Minmetals*, 179 F. Supp. 2d at 139.

If the choice of law made in an agreement is enforceable by the courts of the State of New York, a federal court sitting in New York that hears a contractual dispute pursuant to its diversity jurisdiction would also be obligated to enforce that choice of law, and bankruptcy courts and bank receivers also would generally do so.[249]

Since the Hague Convention entered into force in the United States in 2017,[250] however, the Hague Convention overrides the provisions of the UCC and other New York law to the extent its provisions are inconsistent with those provisions.[251] As noted in the official explanatory report on the Hague Convention (the "*Explanatory Report*~~"),~~"),[252] the convention is "a pure conflict of laws convention," determining the law governing certain issues relating to "securities," as defined and discussed in detail in Section X.A.2(i), that are held with an intermediary.[253] Section 2(1) of the Hague Convention, which establishes the scope of the convention's coverage, does not refer explicitly to the creation or attachment of a security interest in the list of matters that it addresses, but it does state that the convention determines the law applicable to, among other things, the "legal nature and effects against the intermediary and third parties of a disposition of securities held with an intermediary."[254] A "disposition" is "any transfer of title whether outright or by way of security and any grant of a security interest, whether possessory or non-possessory."[255] At the same time, the Hague Convention excludes from its coverage "the contractual or other personal rights and duties of parties to a disposition of securities held with an intermediary."[256] Although attachment relates principally to the rights of the two contract parties against one another, as opposed to the rights of the intermediary and third parties, it can be argued that the language of the Hague Convention mandates the choice of governing law, at least to the extent that the rights of third parties and intermediaries are in question.[257]

We have assumed that each customer agreement will expressly state that it will be governed by New York law. We have also assumed that the FCM will credit the customer's U.S. futures ~~contracts~~, cleared ~~swap contracts~~swaps, foreign futures ~~contracts~~

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249 *See supra* Section VII.C.

250 Three countries have ratified the Hague Convention at this time: the United States, Switzerland and Mauritius. *See* https://www.hcch.net/en/instruments/conventions/status-table/?cid=72.

251 U.S. CONST. art. VI.

252 Roy Goode, Hideki Kanda & Karl Kreuzer, *Explanatory Report on the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary*, HAGUE CONF. ON PRIV. INT'L LAW, *available at* https://assets.hcch.net/upload/expl36en.pdf [hereinafter Explanatory Report].

253 Hague Convention, *supra* note 242, art. 2(1).

254 *Id*. art. 2(1)(b~~)~~).

255 *Id*. art. 1(1)(h).

256 *Id*. art. 2(3)(b).

257 *See* Mayer Brown LLP, *Memorandum of Law for the International Swaps and Derivatives Association, Inc. Regarding Validity and Enforceability of Collateral Arrangements under the ISDA Credit Support Documents* 17-20 (Mar. 1, 2018) [hereinafter Mayer Brown Memorandum].

and securities margin to the account carried for that customer on the FCM's books.[258] Accordingly, if the Hague Convention does govern the choice of law applicable to attachment, assuming that the relevant intermediary has an office in New York, at the time at which it executes the customer agreement, at which it maintains securities accounts (which would appear to include a commodity account like the customer account),[259] then for the reasons discussed in Section X.A.2(ii), the Hague Convention would require the application of New York law to the attachment of the security interest. If the FCM does not have a qualifying office in New York at the time at which it executes the customer agreement, then New York law would apply only if one of the ~~fall-back~~fallback rules discussed in Section X.A.2(ii) leads to that result.

2. Perfection of the Security Interest

(i) *Types of Collateral*

As noted above, although the parties may choose which law governs the agreement under which a security interest is granted, mandatory provisions of law will determine the law that governs perfection of the security interest. In New York, the perfection, the effect of perfection or nonperfection, and the priority of a security interest in collateral is governed by Article 9 of the UCC. Article 9 contains a series of rules specifying the jurisdiction whose laws will govern the perfection and priority of security interests in various types of property. These rules vary, depending upon the type of collateral in question. To the extent that the collateral consists of investment property, the choice of law provisions of the UCC are superseded by the Hague Convention, which determines which law governs the perfection of a security interest in "securities" (as defined in the convention) held with an intermediary. Accordingly, to determine which jurisdiction's law will govern the perfection of a security interest in collateral, it is essential to know how that collateral is categorized under the UCC, and whether it would be viewed as a "security" for purposes of the Hague Convention.

(1) Under the UCC

UCC Section 9-301 provides, in relevant part, that unless a more specific rule is provided, the law governing perfection, the effect of perfection or nonperfection, and the priority of a security interest in collateral is determined by the law of the jurisdiction in which the debtor is located, except with respect to a possessory security interest.[260] However, different rules are established for several types of property,

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258 In other words, even if the FCM in turns hold the customer's securities through an intermediary, the FCM is itself acting as intermediary for the customer within the meaning of the Hague Convention ("[A] person that in the course of a business or other regular activity maintains securities accounts for others or both for others and for its own account and is acting in that capacity."). Hague Convention, *supra* note 242, art. 1(1)(c).

259 *See* Explanatory Report, *supra* note 252.

260 ~~U.C.C.~~N.Y. UCC § 9-301(a), (b) (2012). With respect to possessory security interests, these matters are governed by the law of the jurisdiction in which the collateral is located.

including "investment property" and "deposit accounts." To determine which of these rules apply, then, it is necessary to determine how the four categories of property described in the introduction to this Section- X are defined under the UCC.

Article 9 relies heavily on the definitions and concepts contained in Article 8 to determine the manner in which security interests are perfected. Under Article 9, "investment property" consists of securities, security entitlements, securities accounts, commodity contracts and commodity accounts, each as defined in Article 8 of the UCC.[261] As discussed in more detail below, a "security entitlement" means the rights and property interest of an entitlement holder with respect to a "financial asset" specified in Article 8 of the UCC,[262] and "financial assets" include not only "securities" and similar interests, but also "any property that is held *by a securities intermediary* for another person *in a securities account*" if the parties have agreed to treat the property as a financial asset,[263] so long as the UCC does not prohibit the treatment of the type of property in this manner.[264] Accordingly, security entitlements may relate not only to securities, but also to other assets that the parties have agreed to treat as financial assets, including deposit accounts.

The parties may agree to treat an asset as a "financial asset" only if it is held in a "securities account."[265] A "securities account" is "an account to which a financial asset is or may be credited in accordance with an agreement under which the person maintaining the account undertakes to treat the person for whom the account is maintained as entitled to exercise the rights that comprise the financial asset."[266] A "securities intermediary" includes a "person, including a bank or broker, that in the ordinary course of its business maintains securities accounts for others and is acting in that capacity."[267]

The UCC establishes a separate framework for commodity accounts and commodity contracts, and does not permit a securities intermediary and its customer to agree to treat a commodity contract as a "financial asset."[268] "Commodity accounts" are accounts "maintained by a commodity intermediary in which a commodity contract is carried for a commodity customer,"[269] and "commodity contracts" are commodity futures contracts, options on commodity futures contracts, commodity options, or another contract if the contract or option is either (1) traded on or subject to the rules of a designated contract market under ~~Federal~~federal commodities laws, or (2) traded on a

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261 *Id.* § 9-102(a)(49).

262 *Id.* § 8-102(a)(~~18~~17).

263 *Id.* § 8-102(a)(9) (emphasis added).

264 For example, the UCC provides that a commodity contract is not a financial asset. *Id.* § 8-103(f).

265 *Id.* § 8-102 cmt. 9.

266 *Id.* § 8-501(a).

267 *Id.* § 8-102(a)(14).

268 *Id.* § 8-103(f).

269 *Id.* § 9-102(a)(14).

foreign commodity board of trade, exchange or market and carried on the books of a commodity intermediary for a commodity customer.[270] FCMs are "commodity intermediaries."[271] Pursuant to these definitions, both U.S. futures ~~contracts~~ and foreign futures ~~contracts~~ are considered "commodity contracts" for purposes of the UCC, but cleared ~~swap contracts~~swaps and uncleared swaps are not.[272]

"Securities" delivered to an FCM as margin constitute "financial assets," as described above.[273] They constitute financial assets without any agreement by the FCM and the customer, whether or not the FCM is a securities intermediary.[274] When a security, or any other financial asset, is credited to a customer's securities account with a securities intermediary, the customer acquires a "security entitlement" corresponding to that financial asset.[275]

A "deposit account," for purposes of Article 9, includes a demand, time, or similar account maintained with a bank.[276] The term does not include "investment property" or an account evidenced by an instrument.[277] However, the UCC does not prohibit a securities intermediary and its customer from agreeing to treat as a "financial asset" an interest in a deposit account held through a securities account. Accordingly, under Article 9, "cash" margin delivered to an FCM by a customer may be treated as a "deposit account" if the parties do not agree to treat the margin as investment property but may also be treated as a financial asset, and therefore investment property, if they do agree to treat it in that manner and the account to which it is credited is a securities account.

As noted above, cleared ~~swap contracts~~swaps are not "commodity contracts" for purposes of the UCC. They may therefore be treated as "general

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270 *Id.* § 9-102(a)(15).

271 *Id.* § 9-102(a)(17). "*Commodity intermediaries*~~"~~" also include any person who "in the ordinary course of its business provides clearance or settlement services for a board of trade that has been designated as a contract market pursuant to federal commodities laws." *Id.*

272 Although they are cleared, and held in accounts with FCMs, pursuant to a statutory framework based on the framework for cleared futures contracts, cleared swaps are not "commodity contracts" because they are not *traded* on or subject to the rules of a designated board of trade or a foreign commodity board of trade, exchange or market. *See id.* § 9-102(a)(15).

273 *Id.* § 8-102(a)(9)(i).

274 *Id.*

275 "'Security entitlement' means the rights and property interest of an entitlement holder with respect to a financial asset specified in Part 5" of Article 9. *Id.* § 8-102(a)(17). An "entitlement holder" is a person recorded on the books of a securities intermediary as having a security entitlement against the securities intermediary. *Id.* § 8-102(a)(7). The rights of an entitlement holder include the right to receive all payments and distributions received by the securities intermediary in respect of the financial asset, ~~*Id*~~*id.* § 8-505, and to require the securities intermediary to comply with the entitlement holder's directions with regard to the exercise of rights with respect to the financial asset, *id.* § 8-506. *See generally id.* art. 9, pt. 5.

276 *Id.* § 9-102(a)(29).

277 *Id.*

intangibles," the catch-all definition in Article 9 for property that does not belong within other specified categories.[278] In addition, because they are not "commodity contracts," they may be treated as financial assets, and therefore investment property, if the FCM and its customer agree to treat them in that manner and the account to which they are credited is a securities account.

Uncleared swaps are not carried in an account by the uncleared swaps affiliate. Instead, uncleared swaps are bilateral contracts between the customer and the uncleared swaps affiliate. The rights of the uncleared swaps affiliate under such uncleared swaps constitute "general intangibles" within the meaning of Section 9-102(a)(42) of the UCC.

~~Futures contracts~~U.S. futures, foreign futures ~~contracts~~, cleared ~~swap contracts~~swaps, securities and cash margin will all be credited to a single account (the customer account), which will be viewed by the parties as a "commodity account." The question therefore arises as to whether cleared ~~swap contracts~~swaps and deposit accounts credited to a customer account can be treated as financial assets for purposes of Article 9, because these types of property may be treated as financial assets only if they are held in a "securities account" within the meaning of the UCC.[279] To some extent, the question answers itself – a securities account is "an account to which a financial asset is or may be credited in accordance with an agreement under which the person maintaining the account undertakes to treat the person for whom the account is maintained as entitled to exercise the rights that comprise the financial asset."[280] By agreeing to credit securities to the account, and to treat assets credited to the account as "financial assets," an FCM (*i.e.*, the person maintaining the account) and its customers cause the account to be a securities account for purposes of Article 8, and therefore Article 9, of the UCC. But the definition of "financial asset," by requiring that the account be held by a "securities intermediary," requires that an FCM that agrees to treat the cleared ~~swap contracts~~swaps and deposits as "financial assets" must be a person that "in the ordinary course of its business maintains securities accounts for others *and is acting in that capacity*." The question therefore becomes whether an FCM, acting as an FCM, and maintaining a commodity account, can at the same time be a securities intermediary holding cleared ~~swap contracts~~swaps and cash margin for its customer in a securities account, and whether the same account can be both a commodity account and a securities account.

The UCC itself does not explicitly state that an account can simultaneously be both a commodity account and a security account, but the official commentary makes clear that the drafters of the revisions to Article 8 anticipated that different categories of property held within a commodity account would be governed by

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278 "'General intangible' means any personal property, including things in action, other than accounts, chattel paper, commercial tort claims, deposit accounts, documents, goods, instruments, investment property, letter-of-credit rights, letters of credit, money, and oil, gas, or other minerals before extraction. The term includes payment intangibles and software." *Id.* § 9-102(a)(42).

279 *Id.* § 8-102(a)(9)(iii).

280 *Id.* § 8-501(a).

different provisions of Article 8, which in turn results in different treatment under Article 9.

> The main property that a commodity intermediary holds as collateral for the obligations that the commodity customer may incur under its commodity contracts is not other commodity contracts carried by the customer but the other property that the customer has posted as margin. Typically, this property will be securities. *The commodity intermediary's security interest in such securities is governed by the rules of this Article on security interests in securities, not the rules on security interests in commodity contracts or commodity accounts.*[281]

Furthermore, the official commentary notes that the inclusion of commodity accounts as investment property under Article 9 reflected the close link between the commodities and securities account and the rise in portfolio margining.[282]

There is no reason under the UCC that a single account cannot be a "hybrid" account addressed by both the commodity account and securities account provisions of Article 9.[283] As others have noted,

> [t]he only difference between the hybrid account and the two separately titled and numbered accounts is the fact that the [financial institution] has opted to only have a single account title and number. As discussed below, Article 9 does not even require a secured party to list account numbers when taking a lien in an account.[284]

Moreover, as the commentary to the definitions of "securities account" and "commodity account" demonstrate, there is nothing that requires an account to be exclusively one or the other. Both commodity accounts and securities accounts are described in the official comments in terms of the relationship they form between a financial institution and its

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281 *Id.* § 9-102 cmt. 6.

282 *Id.*

283 "For securities, Article 9 contains rules on security interests, and Article 8 contains rules on the rights of transferees, including secured parties, on such matters as the rights of a transferee if the transfer was itself wrongful and gives rise to an adverse claim. For commodity contracts, Article 9 establishes rules on security interests, but questions of the sort dealt with in Article 8 for securities are left to other law." *Id.* § 9-102 cmt. 6.

284 Craig Unterberg and Alex Grishman, *Treatment Of Hybrid Accounts Under Articles 8 and 9 of the UCC*, Banking Rep. (BNA) (Mar. 12, 2013). This article addressed a proposed hybrid deposit account-securities account structure.

customer, not in terms of a specific account arrangement,[285] and it is clear that both relationships were expected to exist simultaneously in the course of a single FCM-customer relationship.[286] As a result, as long as the customer agreement is clear as to which aspects of the relationship are addressed by the securities account provisions of the UCC and which are addressed by the commodity account provisions, we see no reason that a single account should not constitute both a securities account and a commodity account, and that the security interests in the account and its contents should not be perfected accordingly.

(2) TRADES Regulations and Other Regulations Governing Government Obligations

To the extent that the securities margin consists of bills, notes and bonds issued by the U.S. Treasury ("*Treasury Securities*~~"),~~"), the regulations governing the Treasury/Reserve Automated Debt Entry System ("*TRADES Regulations*~~")~~")[287] may supersede the UCC with respect to certain matters. Similar regulations govern those matters with respect to securities issued by many government-sponsored enterprises ("*GSEs*~~").~~").[288] In the institutional markets, Treasury Securities are issued only in book-entry form,[289] and parties other than banks with accounts at Federal Reserve Banks can hold such securities only in the form of "Security Entitlements" held through "Securities Intermediaries." The TRADES Regulations define and use the term "Security

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285 "A securities account is a consensual arrangement in which the intermediary undertakes to treat the customer as entitled to exercise the rights that comprise the financial asset" ~~U.C.C.~~N.Y. UCC § 8-501 Cmt. 1 (2012). "The terms 'commodity account,' 'commodity contract,' 'commodity customer,' and 'commodity intermediary' are defined in this section. Commodity contracts are not 'securities' or 'financial assets' under Article 8. *See id.* § 8-103(f). Thus, the relationship between commodity intermediaries and commodity customers is not governed by the indirect-holding-system rules of Part 5 of Article 8~~. For securities, Article 9 contains rules on security interests, and Article 8 contains rules on the rights of transferees, including secured parties, on such matters as the rights of a transferee if the transfer was itself wrongful and gives rise to an adverse claim. For commodity contracts, Article 9 establishes rules on security interests, but questions of the sort dealt with in Article 8 for securities are left to other law." *Id.* § 9-102 Cmt. 6.~~." *Id.* § 9-102 Cmt. 6. *See also supra* note 283

286 *See supra* text accompanying note 281.

287 31 C.F.R. Part 357 (2020).

288 *See, e.g.*, 12 C.F.R. Part 615 Subpart O (obligations of the Farm Credit Banks); 12 C.F.R. Part 1511 (obligations of the Resolution Funding Corporation); 18 C.F.R Part 1314 (obligations of the Tennessee Valley Authority); 24 C.F.R. Part 81 Subpart H (obligations of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac)); 24 C.F.R. Part 350 (obligations of the Government National Mortgage Association). Because the GSE regulations cited in this ~~footnote~~note 288 are substantially similar to the TRADES Regulations with respect to the matters discussed in this Section XII, the discussion above will address only the TRADES Regulations.

289 The Treasury's regulations also provide for the "TREASURY DIRECT" program, which is directed at individual holders. That program is not relevant here.

Entitlement" and "Securities Intermediary" in a manner that parallels the corresponding definitions in Article 8 of the UCC.[290]

(3) Under the Hague Convention

As discussed in Section X.A.1, the Hague Convention overrides the choice of law provisions set forth in the UCC with respect to specified matters relating to "securities" held with an intermediary.[291] Among the principal issues governed by the Hague Convention is the determination of the law governing the perfection and priority of a security interest in such securities.[292] The key determinant as to whether the Hague Convention applies to a given matter turns on whether the matter involves "securities."

The scope of the term "securities" in the Hague Convention is similar to the scope of the term "financial assets" under the UCC. "Securities" under the Hague Convention include not only "shares" and "bonds," but also "other financial instruments or financial assets (other than cash), or any interest therein."[293] The Hague Convention does not define "financial instruments" or "financial assets," but the Explanatory Report notes that the definition of "securities" is "intentionally very broad," and "encompasses all types of debt and equity security and is limited only by the fact that the instruments or assets in question must be financial instruments or assets and must in addition be of a kind capable of being credited to a securities account with an intermediary."[294] The Explanatory Report also states that exchange-traded financial futures and options, and credit derivatives, "[c]learly fall[] within the definition."[295] Moreover, the Explanatory Report indicates that the definition is intended to evolve over time and "depends not on the label attached to the instrument or asset, still less on national regulatory law, but rather on whether it is a type of financial asset capable of being credited to a securities account."[296] No "financial asset election" or similar mechanism is required to fall within the Hague Convention's scope.

Accordingly, the Hague Convention will determine which jurisdiction's law will govern the perfection of an FCM's or uncleared swaps affiliate's security interest in securities margin or collateral, as well as their security interests in U.S. futures ~~contracts~~, foreign futures ~~contracts~~ or cleared ~~swap contracts~~swaps (whether or not a

290 12 C.F.R. § 357.2 (2020).

291 U.S. CONST. art. VI.

292 Hague Convention, *supra* note 242, art. 2(1)(c); Explanatory Report, *supra* note 252, at 34.

293 Hague Convention, *supra* note 242, art. 1(1)(a).

294 Explanatory Report, *supra* note 252, at 30.

295 *Id.* at 31.

296 *Id*. Like the UCC, the Hague Convention defines a "securities account" as "an account maintained by an intermediary to which securities may be credited or debited," Hague Convention, *supra* note 242, art. 1(1)(b), and an "intermediary" as "a person that in the course of a business or other regular activity maintains securities accounts for others or both for others and for its own account and is acting in that capacity," Hague Convention, *supra* note 242, art. 1(1)(c).

financial asset election is made with respect to the cleared ~~swap contracts~~swaps).[297] These rules apply even if the agreement is wholly domestic (*i.e.*, both parties are within the United States).

(ii) *Applicable Law*

(1) U.S. Futures ~~Contracts~~, Foreign Futures, Cleared ~~Swap Contracts~~Swaps and Margin in the Form of Securities

UCC Section 9-305(a)(4) provides that the "local law of the commodity intermediary's jurisdiction" governs the perfection, effect of perfection or nonperfection, and priority of a security interest in a commodity contract or commodity account. As discussed in Section X.A.2 above, "commodity contracts" include both U.S. futures ~~contracts~~ and foreign futures ~~contracts~~. To determine the commodity intermediary's jurisdiction, UCC Section 9-305(b) provides that:

> (i) If the agreement between the commodity intermediary and the commodity customer governing the commodity account expressly provides that a particular jurisdiction is the "commodity intermediary's jurisdiction" for purposes of Article 9, then that jurisdiction is the commodity intermediary's jurisdiction. For purposes of this memorandum, the customer agreement would be the relevant agreement.
>
> (ii) If there is no such provision, but the customer agreement provides that it is governed by the law of a particular jurisdiction, then that jurisdiction is the commodity intermediary's jurisdiction.
>
> (iii) If neither of the foregoing applies, and the customer agreement expressly provides that the commodity account is maintained at an office in a particular jurisdiction, then that jurisdiction is the commodity intermediary's jurisdiction.
>
> (iv) If none of the foregoing applies, then the commodity intermediary's jurisdiction is the jurisdiction in which the office identified in an account statement as the office serving the commodity customer's account is located.
>
> (v) If none of the foregoing applies, then the commodity intermediary's jurisdiction is the jurisdiction in which the chief executive office of the commodity intermediary is located.

UCC Section 9-305(a)(3) similarly establishes that the "local law of the securities intermediary's jurisdiction" governs perfection of security interests in a

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297 Uncleared swaps are not held through an intermediary, and therefore would not be within the scope of the Hague Convention. Similarly, cash margin or collateral would not be within the scope of the Hague Convention, because they do not constitute "securities."

~~securities~~security entitlement or securities account. Section ~~-~~ 8-110(e) of the UCC, like UCC Section ~~-~~ 9-305(b), sets forth a series of tests for determining the securities intermediary's jurisdiction that parallels the analysis under UCC Section 9-305(b) set forth above.

To the extent that the securities margin consists of Treasury bills, bonds or notes, then the TRADES Regulations supersede the UCC with respect to determining the choice of law governing perfection of the security interest.[298] The TRADES Regulations provide that the perfection of a security interest in a ~~Security Entitlement~~security entitlement is governed by the "law (not including the conflict-of-law rules) of a ~~Securities~~Security [sic] Intermediary's jurisdiction~~".~~."[299] A "Securities Intermediary's jurisdiction" is selected by reference to the law specified to govern the agreement between the Securities Intermediary through which the Security Entitlement is held (in this case, the Custodian~~.)~~) and the holder of the Security Entitlement pursuant to which the applicable securities account is maintained.[300] If that jurisdiction has not yet adopted "Revised Article 8" of the UCC (the 1994 version that is currently in effect in New York), then the law of the Securities Intermediary's jurisdiction is deemed to be the law of the relevant state as though Revised Article 8 had been adopted by that state.[301] The law of the Securities Intermediary's jurisdiction is determined pursuant to a series of tests that parallels the tests for the commodities intermediary's jurisdiction and the securities intermediary's jurisdiction under the UCC, as described above. Because New York has adopted Revised Article 8, an account agreement specifying that New York law is the securities intermediary's jurisdiction or that is governed by New York law but does not specify the securities intermediary's jurisdiction would, under the TRADES Regulations,

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298 As noted above, similar provisions apply to other types of government securities. The TRADES Regulations also govern when a person acquires a Security Entitlement from a Securities Intermediary, the rights and duties of the Securities Intermediary and Entitlement Holder that arise out of a Security Entitlement, whether the Securities Intermediary owes any duties to an adverse claimant to a Security Entitlement, and whether a person may assert an adverse claim against a person who acquires a Security Entitlement from the Securities Intermediary or against a person who purchases a Security Entitlement or interest therein from an entitlement holder. However, the TRADES Regulations do not govern the attachment of a security interest in a Security Entitlement.

299 31 C.F.R. § 357.11(a)(5). ~~The~~However, the law of the jurisdiction in which the person that creates a security interest is located ~~also~~ governs "whether and how the security interest may be perfected automatically or by filing a financing statement." *Id.* § 357.11(c).

300 *Id.* § 357.11(b)(1). The law of the Securities Intermediary's jurisdiction also governs the acquisition of a Security Entitlement from the Securities Intermediary —*i.e.*, in this case, by ~~LCH~~the FCM from the ~~Custodian~~customer when the T-Bills are transferred to ~~LCH's~~the FCM's segregated account ~~at the Custodian~~. *Id.* § 357.11(a)(1). Under the New York UCC, an Entitlement Holder acquires an interest in a ~~Securities~~Security Entitlement when the Securities Intermediary indicates in its books that a financial asset has been credited to its account. N.Y. ~~U.C.C. Law §~~ UCC § 8501(b)(1) (McKinney 2020). As a result, ~~LCH~~an FCM will acquire an interest in a T-Bill when ~~the Custodian~~its custody bank credits the T-Bill to ~~LCH's~~the FCM's segregated account ~~under the Agreement~~.

301 Since the TRADES Regulations were adopted in this form, some version of Revised Article 8 has been adopted in all 50 states. Regulations Governing Book-Entry Treasury Bonds, Notes and Bills, 67 Fed. Reg. 7,078, 7,079 (Feb. 15, 2002) (to be codified at 31 C.F.R. pt. 357).

result in the application of the substantive law of New York to the perfection of the security interest of a party that holds Treasury bills, bonds or notes through a securities intermediary.

As noted above, we have assumed that each customer agreement is governed by New York law and either does not specify the commodity intermediary's jurisdiction or securities intermediary's jurisdiction or specifies that New York is the commodity intermediary's jurisdiction and securities intermediary's jurisdiction. As a result, the commodity intermediary's jurisdiction and securities intermediary's jurisdiction for each customer account addressed by this memorandum is New York and, as a result, under the UCC and the TRADES Regulations, New York law would govern the perfection, effect of perfection or nonperfection, and priority of a security interest in the customer account and the U.S. futures ~~contracts~~, foreign futures ~~contracts~~ and margin in the form of securities held in the account. This would be true both with respect to the FCM's own security interest in the commodity account, commodity contracts and related security interests, and with respect to any security interest that an uncleared swaps affiliate may have in these assets.

Similarly, to the extent that the margin or collateral received by an uncleared swaps affiliate to secure the obligations of the customer under any uncleared swaps agreement consists of securities, the law governing perfection of that security interest would be determined by applying the analysis in Section 8-110(e) of the UCC to the arrangement under which the collateral is held by the securities intermediary.

Notwithstanding these provisions, insofar as New York law and the TRADES Regulations are concerned, the law of the jurisdiction in which the debtor is located[302] will govern perfection[303] if:

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[302] Section 9-307 of the UCC specifies where a person is "located" for this purpose (and no other purpose). A person that is a "registered organization" formed under the laws of a state, territory or insular possession of the United States is deemed to be located in the state, territory or insular possession under whose laws it was formed. A debtor organized under the laws of a non-U.S. jurisdiction is located in that jurisdiction if the law of that jurisdiction "generally requires information concerning the existence of a nonpossessory security interest to be made generally available in a filing, recording, or registration system as a condition or result of the security interest's obtaining priority over the rights of a lien creditor with respect to the collateral." ~~U.C.C.~~N.Y. UCC § 9-307 (2012). Special rules apply to banking organizations, and to entities formed under federal law. The TRADES Regulations specify that the test contained in Section 9-307 will determine the debtor's location for purposes of the TRADES Regulations as well. 31 C.F.R. § 357.11(c) (2020).

[303] It is common practice to perfect in both jurisdictions. Perfecting in one jurisdiction or in one manner does not impair perfection in the other jurisdiction or in the other manner, but such perfection is not sufficient for purposes of New York law unless it is perfected in the jurisdiction required by New York law.

(i) the FCM or uncleared swaps affiliate wishes to perfect its security interest by filing~~,~~; or

(ii) the customer debtor is a commodity intermediary[304] that creates a security interest in a commodity contract or commodity account, or a securities intermediary that creates a security interest in investment property.[305]

If a financial asset election has been made, cleared ~~swap contracts~~swaps may be treated as financial assets, in which case the discussion of securities and security entitlements above would apply equally to these transactions. If no financial asset election has been made, then the law governing perfection of a security interest in these transactions would be the law of the jurisdiction in which the customer debtor is located, within the meaning of Section~~-~~ 9-307 of the UCC.[306]

Since 2017,[307] however, these tests under the UCC[308] have been superseded by the Hague Convention. To determine which law will apply to these matters, the Hague Convention specifies a series of tests — similar to those set forth in the UCC to determine the commodities intermediary's jurisdiction or securities intermediary's jurisdiction, as discussed above — to determine the jurisdiction whose law will govern the matters addressed by the convention. The "primary rule" established by the Hague Convention is that the law governing these matters is "the law in force in the State expressly agreed in the account agreement as the State whose law governs the account agreement, or, if the account agreement expressly provides that another law is applicable to all such issues, that other law."[309] However, this rule applies only if the relevant intermediary holding the securities has an office in the relevant jurisdiction, at

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304 *I.e.*, an FCM or a person that in the ordinary course of its business provides clearance or settlement services for a board of trade that has been designated as a contract market pursuant to federal commodities law – but not a foreign commodities broker. ~~U.C.C. § 9102~~N.Y. UCC § 9-102(a)(14) (2012).

305 *Id.* § 9-305(c).

306 *Id.* § 9-301(a).

307 To the extent an asset falls within the scope of the Hague Convention, the Hague Convention has governed the choice of the law governing perfection and priority of a security interest in that asset since the convention entered into force on April 1, 2017, even if the security interest was created before that date. However, if an agreement contained a term that was effective under the law governing that agreement providing that the law of a particular jurisdiction governed any of the issues within the scope of the Hague Convention, then that law would apply to all matters within the scope of the Hague Convention, so long as the agreement satisfies the "qualifying office." *See* Hague Convention, *supra* note 242, arts. 16(3), 16(4).

308 The effect of the Hague Convention on the application of the TRADES Regulations is less clear. *See* Mayer Brown Memorandum at 6. We have not analyzed the question, as it is complex and does not appear to have a significant impact on the issues addressed in this memorandum. We have assumed for purposes of this memorandum that the Hague Convention will supersede the TRADES Regulations to the extent of any conflict.

309 Hague Convention, *supra* note 242, art. 4(1).

the time when it enters into the agreement, at which it provides specified services related to the maintenance of securities accounts (the "qualified office" test).[310]

If the "primary rule" does not apply — whether because the account agreement does not specify a governing law or the securities intermediary does not have an office in the specified jurisdiction at the relevant time — then the "~~fall-back~~fallback rules" apply. Under the ~~fall-back~~fallback rules, the matters addressed by the Hague Convention will be governed by:

> (i) if the account agreement "expressly and unambiguously state[s]" that the relevant intermediary entered into the agreement through a particular office, ~~then~~ the law of the jurisdiction in which that office is located;
>
> (ii) if the provision above does not apply, the jurisdiction under whose law the relevant intermediary is incorporated or organized when the account is opened; and
>
> (iii) if neither provision above applies, the law of the jurisdiction in which the relevant intermediary has its place of business or, if it has more than one, its principal place of business when the account is opened.[311]

The law chosen under these rules will apply, whether or not the jurisdiction in question has become bound by the Hague Convention.[312]

We have assumed that each customer agreement will expressly state that it will be governed by New York law. We have also assumed that the FCM will credit the customer's U.S. futures ~~contracts~~, cleared ~~swap contracts~~swaps, foreign futures ~~contracts~~ and securities margin to the account carried for that customer on the FCM's books.[313] Accordingly, assuming that the FCM has an office in New York, at the time at which it executes the customer agreement, at which it maintains securities accounts (which would appear to include a commodity account like the customer account),[314] then the Hague Convention (like the UCC) would require the application of New York law to the matters addressed by the Hague Convention. This would be true even in circumstances in which the UCC might otherwise apply the law of the jurisdiction in which the customer is "located." If the FCM does not have a qualifying office in New York at the time at which

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310 *Id.*

311 *Id.* art. 5.

312 *Id.* art. 9.

313 In other words, even if the FCM in ~~turns hold~~turn holds the customer's securities through an intermediary, the FCM is itself acting as intermediary for the customer within the meaning of the Hague Convention ("[A] person that in the course of a business or other regular activity maintains securities accounts for others or both for others and for its own account and is acting in that capacity."). ~~Hague Convention, *supra* note 172,~~*Id.* art. 1(1)(c).

314 *See* Explanatory Report, *supra* note 252.

it executes the customer agreement, then New York law would apply only if one of the ~~fall-back~~fallback rules leads to that result.

With respect to the security interest in securities margin pledged to secure the uncleared swaps, the relevant intermediary in respect of securities collateral posted by the customer to the uncleared swaps affiliate in connection with the uncleared swaps would be the securities intermediary (within the meaning of the UCC) at which the uncleared swaps affiliate holds the customer's securities collateral. Thus, if the agreement governing that account specifies that it is governed by New York law and the FCM itself, if acting as securities intermediary, or the securities intermediary holding the relevant assets has a qualifying office in New York at the relevant time, then New York law will apply to the matters addressed by the Hague Convention.

Importantly, the conflict of laws rules of the Hague Convention require the application of the *domestic (substantive) rules* of the jurisdiction whose laws apply under the Hague Convention — not the conflict of laws rules of that jurisdiction.[315] This would mean that the laws of the "state" in question (the United States, in the case of New York) would govern the matters addressed by the Hague Convention. However, in a multi-unit state like the United States, "if the law in force in a territorial unit of a Multi-unit State designates the law of another territorial unit of that State to govern perfection by public filing, recording or registration, the law of that other territorial unit governs that issue."[316] As noted above, under the Hague Convention conflict of laws provisions, New York law would govern perfection. As applied to this context, if New York law provides that the law of another U.S. state or territory governs perfection by filing, then the law of that other state will govern perfection by filing. However, if New York law provides that the law of a non-U.S. jurisdiction (such as the United Kingdom) governs perfection by filing, then New York law, not the law of such non-U.S. jurisdiction, will govern perfection by filing. Because, under the assumptions on which this memorandum is based, New York law would govern the matters addressed by the Hague Convention, this exception does not apply.

Accordingly, under the assumptions set forth in this memorandum, New York law would govern the perfection of the security interests created by the customer agreement or by an uncleared swaps agreement that creates a security interest over a securities account located in New York.

(2) Margin in the Form of "Cash"

As described in Section- VI.B above, when a customer posts margin in the form of "cash," or the FCM receives funds accruing to the customer as a result of the customer's U.S. futures ~~contracts~~ or cleared ~~swap contracts~~swaps, the FCM is required to hold those customer funds ("*cash margin*~~")~~") in compliance with the CFTC's segregation regulations. Those customer funds necessarily must be held in the form of a deposit

315 *Id.* at 113.

316 Hague Convention, *supra* note 242, art. 12(2)(b).

account, and cannot be held by the FCM directly unless it is itself a bank or trust company that can accept deposits. Accordingly, as described above, when the margin is delivered to the FCM, it is initially deposited in an account with a bank or trust company that has provided the necessary acknowledgement required by CEA regulations.[317] The deposit account is held in the name of the FCM, and must be titled "under an account name that clearly identifies [the funds on deposit] as futures customer funds and shows that such funds are segregated as required by sections 4d(a) and 4d(b) of the Act" and the CFTC's regulations.[318] This "cash" margin is subject to immediate withdrawal by the FCM, and therefore constitutes a "deposit account" for purposes of the UCC.[319] The FCM must maintain all cash margin in such deposit accounts, or in the FCM's omnibus customer margin account with the DCO. If the FCM transfers the funds to the DCO for credit to the FCM's omnibus customer margin account, the DCO must hold the funds in the DCO's omnibus account for its FCM customers; the DCO, in turn, must acknowledge that the funds are funds of the FCM's customers, and hold the margin in permitted depositaries in accounts complying with requirements corresponding to those applicable to the FCM's own segregated accounts.[320] The FCM credits the customer's ~~customer~~ account with the amount of funds that the FCM holds for the customer in either manner.

The Hague Convention would not determine the law applicable to perfection of the FCM's security interest in cash margin, because the term "financial assets" under the Hague Convention does not include "cash," "whether the cash is credited to the securities account or to a separate cash account maintained by the intermediary."[321]

As noted above, a securities intermediary and its customer may agree to treat a deposit account as a "financial asset" within a securities account. If this election is made, then, on the basis of the assumptions set forth above, New York law would govern the perfection of the security interest in such accounts under the provisions of the UCC applicable to securities accounts as described above.

However, if the deposit account is not treated as a financial asset, then perfection and priority of a security interest in the account would be governed by UCC Section 9-304, which provides that the "local law of a bank's jurisdiction" would govern these matters. The bank's jurisdiction is determined by reference to the agreement governing the deposit account, in the same manner as the commodities intermediary's

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317 17 C.F.R. §§ 1.20(a)-(d), 22.5 ~~)~~((2020). If agreed by the customer, an FCM may invest the cash in investments permitted under the CFTC's regulations. *Id.* § 1.25. Such investments must be held in accordance with the segregation requirements. *Id.* § 1.26. To the extent such investments are security entitlements, the FCM's security interest in such investments ~~are~~is perfected as described in Section X.B.2 ~~above~~below.

318 *Id.* §§ 1.20(a)-(d), 22.6.

319 ~~U.C.C.~~N.Y. UCC § 9-102(a)(29) (2012).

320 17 C.F.R. §§ 1.20; 22.3 (2020).

321 Explanatory Report, *supra* note 252, at 32.

jurisdiction and the securities intermediary's jurisdiction are determined as described above.[322] If the account agreement establishing the relevant bank account is governed by New York law and does not specify that the law of another state is the law of the bank's jurisdiction, or if the agreement specifies that New York is the bank's jurisdiction, then New York law would govern perfection of a security interest in the account.

(3) Uncleared Swaps[323]

As noted above, uncleared ~~swap transactions~~swaps do not constitute commodity contracts for purposes of the UCC. Moreover, they will not constitute securities, or financial assets, for purposes of the Hague Convention because they are not held through an intermediary. As general intangibles, uncleared ~~swap transactions~~swaps are subject to the general "default" choice of law rule under the UCC, which provides that perfection of a security interest is governed by the law of the jurisdiction in which the debtor is located.[324] Accordingly, New York law will govern the perfection of security interests in uncleared swaps only if the customer is "located" in New York, within the meaning of Section 9-307 of the UCC.

B. Procedures Required to Perfect Security Interests in Contracts and Property Held in the Customer Account or Executed with Uncleared Swaps Affiliate

This section describes the procedures that must be completed to perfect a security interest in each type of property described above when New York law governs perfection. To the extent that the Hague Convention or the UCC ~~specify~~specifies that New York law does not govern perfection, the laws of the applicable jurisdiction must be consulted. It is also prudent to consult the laws of the jurisdiction in which the customer ~~and~~or any collateral ~~are~~is located, whether or not required under New York law, to determine whether compliance with the laws of those jurisdictions is required or would be necessary or advisable under those or other laws, notwithstanding New York laws that provide otherwise.[325]

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322 ~~U.C.C.~~N.Y. UCC § 9-304(b) (2012). Section 9-304 does not include a provision~~,~~ corresponding to 9-305(c) (creating an exception to the general rule for security interests granted by a securities intermediary or commodity intermediary in investment property).

323 We note that the ~~U.S.~~United States has ratified the U.N. Convention on the Assignment of Receivables in International Trade, *available at* https://uncitral.un.org/en/texts/securityinterests/conventions/receivables, which may affect an assignment of "a receivable owed on the termination of all outstanding transactions." However, this convention has not yet entered into force.

324 ~~U.C.C.~~N.Y. UCC § 9-301(a) (2012).

325 As noted ~~in footnote~~*supra* note 303 ~~above,~~, perfecting in more than one jurisdiction or in more than one manner does not impair the effectiveness of perfection in accordance with the requirements of New York law.

1. U.S. Futures ~~Contracts~~ and Foreign Futures

Under the UCC, a security interest in "investment property" is perfected by control. Perfection continues from the time the secured party obtains control and, in the case of commodity contracts and commodity accounts, continues until the secured party ceases to have control.[326]

An FCM is deemed to have control of a commodity contract if the FCM is the commodity intermediary with which the commodity contract is carried.[327] A party other than the carrying FCM, such as an uncleared swaps affiliate that takes a security interest in the customer's ~~customer~~ account, is deemed to control the commodity contracts in the account if the customer, the uncleared swaps affiliate~~,~~ and the FCM have agreed that the FCM will apply any value distributed on account of the commodity contract as directed by the uncleared swaps affiliate without further consent by the customer.[328] In either case, if the secured party has "control" over all the commodity contracts carried in the customer account, then the secured party has control over the customer account and therefore perfects its security interest in the commodity account itself as well.[329]

By obtaining control over the customer account, a secured party perfects its security interest in the customer account, including ~~all~~the obligation of the FCM to pay to the customer the balances credited to the account.[330] Accordingly, the security interest of the FCM should be automatically perfected, and the security interest of third parties who gain control of the commodity contracts should thereby be perfected, in respect of not only the commodity contracts themselves, but also in the other property

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326 ~~U.C.C.~~N.Y. UCC § 9-314(c) (2012).

327 *Id.* § 9-106(b)(1).

328 *Id.* § 9-106(b)(2). While commodity account control agreements are not as common as securities account control agreements and deposit account control agreements, forms of these agreements are in common use. The official comment to Section 9-106 states that ~~"Of~~, "[o]f course, an agreement that provides that (without further consent of the debtor) the securities intermediary or commodity intermediary will honor instructions from the secured party concerning a securities account or commodity account described as such is sufficient. Such an agreement necessarily implies that the intermediary will honor instructions concerning all security entitlements or commodity contracts carried in the account and thus affords the secured party control of all the security entitlements or commodity contracts." *Id.* § 9-106 Cmt. 4.

329 *Id.* § 9-106(c).

330 In discussing the analogous provisions applicable to securities accounts, the Official Comment to ~~U.C.C.~~UCC § 9-108 states that "given the broad definition of 'securities account' in Section 8-501, a security interest in a securities account also includes all other rights of the debtor against the securities intermediary arising out of the securities account. For example, a security interest in a securities account would include credit balances due to the debtor from the securities intermediary, whether or not they are proceeds of a security entitlement." *Id.* §- 9-108 cmt. 4.

credited to the commodity account,[331] without further action.[332] Moreover, the statutory framework established by the CEA establishes the FCM's right to use the margin delivered to the FCM by the customer as a matter of federal law and requires the FCM to hold the margin in accordance with requirements amounting to ~~a specific~~ statutory ~~trust~~trusts,[333] as discussed in Section ~~-~~ VI.B above and as described in Section ~~-~~ XI.B.2 below, the FCM generally need not rely upon a security interest in the customer funds as the basis for utilizing customer funds to satisfy obligations to DCOs arising in the course of liquidating the customer's ~~customer~~ transactions. The CEA does not require an FCM to obtain a security interest, ~~most likely~~possibly because a security interest is not needed to complete the liquidation process, and because the customer's interest in customer funds held by the FCM is limited to its undivided beneficial interest in the segregated assets.

However, ~~several factors complicate~~it would be unwise to rely upon this analysis~~. First, an FCM may wish to obtain~~ as a basis for failing to establish and perfect a

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331 As discussed in Section X.A.2(i), the customer account may be viewed as a hybrid account, treated partially as a commodity account and partially as a security account. Assuming that view is correct, perfection of the security interest in the commodity account would perfect the security interest in all property credited to the property that is deemed to be part of the commodity account. Perfection of the security interest in the security account would perfect the security interest in all property credited to the property that is deemed to be part of the security account.

332 *Cf.* 9A Hawkland UCC Series §~ 9-102:12 [Rev], discussed further in ~~Section~~ Sections X.B.2 and X.B.3 below. *But see* Thomas E. Plank, Security Interests in Deposit Accounts, Securities Accounts, and Commodity Accounts: Correcting Article 9's Confusion of Contract and Property, 69 Okla. L. Rev. 339, (2017), which asserts (without citation) that ~~"A~~"[a] security interest in a securities account does *not* include credit balances due to the debtor. The securities account includes the credit balances, and the entitlement holder has a security entitlement to the amount of such credit balances. This third sentence, however, ignores the important analytical step of identifying the property item in which the secured party has a security interest. As discussed above in Subpart B, the secured party can have a security interest in the debtor's security entitlement that enables the secured party, upon the debtor's default, to exercise the rights of the entitlement holder to the credit balances. The property item subject to the security interest is neither the securities account nor the credit balances in the securities account." This comment appears to assume that a cash balance in a securities account must be a reference to a deposit account holding the cash to which the cash balance refers and which is held as a financial asset, rather than "a personal claim against the intermediary" (as referenced in Official Comment 3 to ~~U.C.C.~~UCC § 9-314). ~~U.C.C. §~~ N.Y. UCC § 9-314 cmt. 3 (2012). The author would presumably come to the same conclusion as to the nature of cash margin. As discussed below, we do not believe this understanding to be correct in the absence of a financial asset election, but the existence of this perspective is one of the reasons that perfecting the security interest in the various components of the commodity account is important.

333 *Cf.* §~ 1:2. Sources of law, generally, 1 Com. Asset-Based Fin. §~ 1:2 ("A large and expanding federal law overlay affects commercial lending. Federal consumer regulation alters how a transaction is structured and disclosed.~~. . .~~ . . . One example of a lien created by federal law that may trump creditor expectations under Article 9 of the U.C.C. is a statutory trust under the Perishable Agricultural Commodities Act in favor of unpaid sellers of such commodities. Likewise, the Poultry Producers Financial Protection Act provides that poultry, inventories, receivables, and proceeds must be held in trust by certain dealers for the benefit of unpaid cash sellers or poultry growers.").

security interest in the property customer's account ~~to secure other obligations and~~and related property, if only as a result of the extensive debate and disagreement relating to these matters that has transpired both before and after the adoption of the Dodd-Frank Act. In addition, as noted above, the Official Commentary to Article 9 of the UCC indicates that securities margin held in a commodities account should be analyzed under the provisions of Articles 8 and 9 relating to security entitlements and cleared ~~swap transactions~~swaps may be treated as financial assets for purposes of perfection; as a result, many customer accounts ~~must~~will be characterized as both commodity accounts and security accounts and therefore must be perfected under the rules providing for both types of accounts. ~~In addition, even though it is clear that no individual customer has an interest in any particular part of the customer funds held in segregation, the customer funds as a whole are held for the benefit of customers, the references to treating the funds as "belonging" to the customers creates the potential for confusion as to the extent of the customers' interest in the funds in segregation, as opposed to their claims against the FCM in respect of the account balance.~~[334]In addition, an FCM may wish to obtain a security interest in the customer's account to secure other obligations of the customer to the FCM or its affiliates. A perfected security interest may also be helpful in preventing the imposition of tax liens or other liens by other parties that could interfere with the FCM's rights against the customer or under the customer agreement. It is also possible that an FCM dealing with a customer outside the United States may wish to maintain the ability to rely upon its rights as a secured party to address issues arising under the customer's local law. In any event, it is market practice to perfect the security interest in the various components held in the commodity account, because, among other things, a perfected security interest provides protection to the FCM against the need to defend its interests against those of third-party creditors of the customer.

2. Margin in the Form of Securities and Cleared Swaps Where a Financial Asset Election Is Made

As discussed above, security entitlements and security accounts are also investment property under Article 9 of the UCC.[335] A "*security entitlement*" arises when a securities intermediary indicates by book entry that a financial asset has been credited to its customer's securities account, or receives a financial asset from the person or acquires a financial asset for the person and, in either case, accepts it for credit to the person's securities account.[336] Financial assets include both securities and any property

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[334] ~~". . . Congress contemplated that customer funds covered by section 6d would sometimes, if not usually, take the form of an undivided interest in a body of assets whose individual components would vary, and that the protections of the section extend to such interests." *Brief of Amicus Curiae Commodity Futures Trading Commission in Support of Appellant and of Reversal on Selected Issues* at 10, *Grede v. FCStone LLC*, 746 F.3d 244 (7th Cir. 2014) (Nos. 13-1232, 13-1278), 2013 WL 2954191. *See also supra* note 85 and accompanying text.~~

[335] ~~U.C.C.~~N.Y. UCC § 9-102(a)(49) (2012).

[336] *Id.* § 8-501(b). A security entitlement is also acquired when the securities intermediary ~~is~~ "becomes obligated under other law, regulation, or rule to credit a financial asset to the [customer's] securities account." *Id.*

that is held by a securities intermediary for its customer in a securities account if the securities intermediary has expressly agreed with the customer that the property is to be treated as a financial asset~~.~~.[337] Accordingly, both the margin delivered by the customer in the form of securities and, to the extent ~~an~~a financial asset election has been made with respect to cleared swaps, the cleared swaps will be financial assets in which the customer holds a security entitlement.

Like a security interest in a commodity contract, a security interest in a security entitlement with respect to a financial asset is perfected by control.[338] For this purpose, "[i]f an interest in a security entitlement is granted by the entitlement holder to the entitlement holder's own securities intermediary, the securities intermediary has control."[339] As a result, if a customer has granted a security interest to its FCM, as securities intermediary, in security entitlements or other properly designated financial assets held in an account designated as a securities account, that security interest will be perfected automatically. A party other than the FCM, such as its uncleared swaps affiliate, can obtain control over a security entitlement held by the FCM by obtaining the FCM's agreement that it will comply with entitlement orders originated by the party with respect to that security entitlement without further consent by the customer.[340] If the secured party has control of all security entitlements carried in the securities account, then it also has control over the securities account.[341]

A security interest in a security entitlement perfected by control remains perfected from the time the secured party obtains control and remains perfected until the secured party does not have control *and* the debtor is or becomes the entitlement holder.[342] Accordingly, if the secured party rehypothecates the security entitlement or, as may be the case with an FCM, delivers the security entitlement to a DCO as initial margin, or sells the security entitlement in the market and uses the proceeds for the purposes permitted under the CEA, the secured party's security interest would not become unperfected.[343]

The security interest of the uncleared swaps affiliate in the securities margin and cleared ~~swap transactions~~swaps, and the customer account to the extent that it is a securities account, may be perfected by control by means of a securities account

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337 *Id.* § ~~9~~8-102(~~b~~a)(9).

338 *Id.* § 9-106(a).

339 *Id.* § 8-106(e).

340 *Id.* § 8-106(d)(2). Again, forms of securities account control agreements are widely available. The FCM's obligations to accept entitlement orders originated by the third party may be subject to the right of the FCM to obtain satisfaction of the customer's obligations to the FCM, so long as the customer's consent is not required as a condition to the exercise of control by either the FCM or the third party.

341 *Id.* §~ 9-106(c).

342 *Id.* § 9-314(c).

343 *See id.* § 9-314 cmt. 3.

control agreement executed by the customer, the FCM, as securities intermediary, and the uncleared swaps affiliate, as secured party. The uncleared swaps affiliate may also perfect its security interest by filing a financing statement,[344] but a security interest perfected by control will have priority over a security interest perfected by filing.[345]

3. Margin in the Form of Cash

As described in Section ~~-~~ VI.B and Section ~~-~~ X.A.2(ii) above, an FCM must hold cash margin in an account with a bank or trust company that has entered into the necessary acknowledgement required by CEA regulations, ~~or~~ in the FCM's omnibus customer margin account at a DCO or, in the case of cash margin relating to foreign futures, with its foreign futures broker.[346]

Under the CFTC's regulations, when the funds are deposited at the FCM's own segregated account or separate account at a bank or trust company, or at a foreign futures broker, the ~~depositary~~depository is permitted to accept the FCM's instructions and comply with them "without further inquiry" as to their compliance with CFTC regulations or the CEA, so long as the ~~depositary~~depository does not have "notice of or actual knowledge of a potential violation" by the FCM; the FCM's customers have no right to access the account.[347] Similarly, when the FCM delivers customer funds to a DCO to be held in the DCO's omnibus account for its FCM customers and credited to the FCM's omnibus customer margin account, the customers of the FCM have no right to access that account, the DCO takes instructions only from the FCM (subject to the DCO's rights to use the margin in relation to customer transactions), and the DCO's ~~depositary~~depository takes instructions only from the DCO. ~~The~~Both a foreign futures broker and a DCO ~~holds~~hold the FCM's undivided interest in the ~~DCO's segregated~~ accounts opened by the FCM for the benefit of the FCM, acting on behalf of its customers.

~~As an initial matter, it is not clear that separate perfection of the FCM's security interest in the cash margin would be required, absent the complications described in Section X.B.1 above. Under the common law upon which the FCM-customer relationship is based~~As discussed above in Section X.B.1, it may be argued that it is not necessary to perfect the security interest of the FCM in cash balances held in a customer's account separately from the perfection of the account itself. As described there, perfection of a security interest in the account should perfect the security interest in

344 *Id.* §~~-~~ 9-312(a).

345 *Id.* § 9-328(a).

346 17 C.F.R. §§ 1.20(a)-(d), 22.5 (2020), 30.7(b). If agreed by the customer, an FCM may invest the cash in investments permitted under the CFTC's regulations. *Id.* § 1.25~~-~~, 22.2(e), 30.7(h). Such investments must be held in accordance with the applicable segregation or separate account requirements. *Id.* § 1.26~~-~~, 22.4, 30.7(h). To the extent such investments are security entitlements, the FCM's security interest in such investments ~~are~~is perfected as described in Section X.B.2 above.

347 *Id.* § 1.20, 22.5, 30.7 App. E.

the obligation of the FCM to pay the cash balance to the customer when required under the terms of the account.

Moreover, the customer does not have an interest in the specific cash that it has delivered to the FCM or received in respect of its transactions, but only an undivided interest in the body of assets held under the customer property rules.[348] The FCM's obligation to return to a defaulting customer any customer funds relating to U.S. futures or cleared swaps is limited to the customer funds remaining after the FCM has liquidated the customer's U.S. futures and cleared swaps and applied any customer funds held in segregation to settle to the customer's transactions. As discussed in Section XI.B.2, to the extent that the FCM is required to make payment to a DCO in connection with a customer's transactions, it is permitted by the CEA, and the terms of the specific statutory trust under which the customer funds are held, to apply those funds directly to the obligations that the FCM has incurred in respect of the customer's transactions. The customer is entitled only to the return of the residue remaining after all those obligations are satisfied.

Furthermore, even in the absence of the CEA and related regulations, the commingling of customer funds by an FCM converts the customer's interest in the cash margin from an interest in property held by the FCM to a claim against the FCM to repay the amount of cash to the customer.[349] Under New York law, a party may generally set off "debts" that are "mutual," in the sense that they are "due to and from the same persons in the same capacity."[350] This right derives both from the common law, and from Section 151 of the New York Debtor and Creditor Law. Under the common law, a party may set off obligations that are owed to it by an insolvent debtor, and that are currently due and payable, against obligations owed by the creditor to the debtor.[351] New York courts have also recognized that parties may agree to accelerate and set off otherwise unmatured or contingent debts[352] and, even in the absence of such an agreement, Section 151 of the New York Debtor and Creditor Law expressly permits a party to set off its obligations against unmatured debts of a counterparty that is the subject of a

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348 *See supra* note 137 and accompanying text.

349 *See* ~~footnotes 87-88 above and accompanying text. *Cf.*~~ RESTATEMENT (SECOND) OF AGENCY, § 398 cmt. c (1958) ("If the funds are properly mingled, the inference is that the agent becomes a debtor to the amount received for the principal, but that he agrees to maintain enough in the fund to pay the principal, who has a charge upon the fund to the amount of the debt. It may be understood that an agent is privileged to mingle the funds or fungible goods of various principals, as where a collecting agent has an account with a bank in which he keeps the funds of all of his clients, or where a depository of grain mingles that of all the owners. In these situations, the principals at any given moment are tenants in common of the claim against the bank or of the grain.~~")~~.").

350 *In re Westchester Structures, Inc.*, 181 B.R. 730, 740 (Bankr. S.D.N.Y. 1995).

351 *Jordan* v. *National Shoe & Leather Bank*, 74 N.Y. 467 (1878).

352 *Updike* v. *Manufacturers Trust Company*, 243 App. Div. 15 (N.Y. App. Div. 1934), *aff'd*, 267 N.Y. 528 (1935), *cert. denied*, 296 U.S. 648 (1935).

bankruptcy proceeding and under certain other circumstances.[353] The customer incurs the obligation to reimburse the FCM, as the customer's agent, for any funds expended in maintaining or liquidating the customer's ~~customer~~ transactions. The FCM, as the customer's agent, owes the customer the repayment of the balance of its customer account. The two obligations are incurred in the course of the same course of dealing, and in the same capacities.[354] Accordingly, the FCM should have the right to offset its ~~repayment~~ obligation to pay the cash balance in the account against any amounts due to the FCM from the customer. This right would exist even in the absence of an express provision in the customer agreement, although a contractual provision may, as noted above, ensure that the FCM may exercise that setoff right even when it would not otherwise be permitted to do so under the common law or Section 151.

~~Moreover, under CFTC regulations and the operation of the statutory trust, the FCM's obligation to return to a defaulting customer any customer funds relating to futures contracts or cleared swap contracts is limited to the customer funds remaining after the FCM has liquidated the customer's customer transactions and applied any customer funds held in segregation to settle to the customer's customer transactions. As discussed in Section~~ Nonetheless, as also noted in Section X.B.1 above, there are a number of reasons that it is prudent to perfect the security interest in the cash margin separately, as well as through perfection of the security interest in the account itself. Perfection may occur in two ways: by means of "control" of a deposit account, or by the making of a financial asset election with respect to the funds credited to the customer's account and perfection by "control" of the customer's account as a securities account.

~~XI.B.2, to the extent that the FCM is required to make payment to a DCO in connection with a customer's transactions, it is permitted by the CEA, and the terms of the specific statutory trust under which the customer funds are held, to apply those funds directly to the obligations that the FCM has incurred in respect of the customer's transactions. The customer is entitled only to the return of the residue remaining after all those obligations are satisfied.~~

~~Furthermore, as discussed in Section X.B.1, perfection of a security interest in a commodities account a secured party should perfect its security interest in the customer account, including all balances credited to the account, without further action.~~

If the FCM seeks to perfect its security interest in the cash margin pursuant to the rules applicable to deposit accounts, it may do so by obtaining "control" over the deposit account. Under Article 9, as in effect in New York, a secured party has

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353 N.Y. DEBT. & CRED. L. § 151 (McKinney 2020).

354 If the amounts owed by the customer do not accrue until after the commencement of a bankruptcy or insolvency proceeding, there may be a question as to mutuality if a party seeks to rely upon a setoff of pre-commencement margin balances against post-commencement customer obligations. *See In re Lehman Bros. Inc.*, 458 B.R. 134, 143 (Bankr. S.D.N.Y. 2011) (finding that Section 561 of the Bankruptcy Code did not protect a contractual right of setoff where mutuality was lacking).

control of a deposit account if, among other things, (1) the secured party becomes the bank's customer with respect to the deposit account, or (2) another person has control of the deposit account on behalf of the secured party or, having previously acquired control of the deposit account, acknowledges that it has control on behalf of the secured party.[355] A secured party that has satisfied these requirements has control, within the meaning of Article 9, even if the debtor retains the right to direct the disposition of funds from the deposit account.[356]

Because the cash margin is delivered to the FCM by the customer and deposited in the account in the FCM's name, the FCM's security interest in the cash margin is perfected pursuant to the first of these options. The fact that the FCM must hold the cash margin as "belonging to its customers" does not interfere with this control, nor does the fact that the FCM must comply with CFTC regulations governing its operation of the account. The critical factor is that the *customer* does not control the account.

Unlike Article 8, which provides that a security interest in security entitlements remains perfected until the debtor once again becomes the entitlement holder (even if the secured party no longer has control), a security interest in a deposit account ceases to be perfected if the secured party fails to maintain control. Accordingly, when the FCM sends the cash margin to a DCO or a foreign futures broker, whether to satisfy obligations arising in respect of the customer's ~~customer~~ transactions or to be held as initial margin or margin under the rules governing the foreign future, the FCM's security interest would become unperfected unless the FCM obtains control in some other manner.[357] Section 9-104(d)(5)[358] should provide the FCM with continuing control over the cash margin while it is credited to its omnibus customer margin account at the DCO and held in the DCO's omnibus account for its FCM customers, because the DCO, by crediting the cash margin to the FCM's omnibus customer margin account, acknowledges

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355 ~~U.C.C.~~N.Y. UCC § 9-104(a) (2012). A secured party also has control if: (1) the secured party is the bank with which the deposit account is maintained, an option that is not available in the case of FCMs in general, because the FCM is not itself a bank; (2) the debtor, secured party, and bank have agreed that the bank will comply with instructions originated by the secured party directing disposition of the funds in the deposit account without further consent by the debtor; or (3) the name on the deposit account is the name of the secured party or indicates that the secured party has a security interest in the deposit account. *Id.*

356 *Id*. § 9-104(b).

357 Under the framework established by the CEA, this would be a nonsensical outcome; the margin held at the DCO remains part of the ~~specific statutory trust~~technical trust created by Section 4d of the CEA, whether it is held at the DCO or in the FCM's segregated account at its own depository, and under Section ~~4d2 of the CEA~~4d, the FCM continues to have the authority to use the funds for the purposes specified in that Act. The same analysis would apply to funds provided to a foreign futures broker in connection with foreign futures cleared for the FCM's customer.

358 Section 9-104(d)(5) provides that the secured party has control if another person has control of the deposit account on behalf of the secured party or, having previously acquired control of the deposit account, acknowledges that it has control on behalf of the secured party. This provision of the New York UCC is a non-uniform variation from the Official Text of the Uniform Commercial Code.

that it controls an undivided portion of the DCO's own segregated account on behalf of the FCM. Similarly, when the FCM provides the funds to a foreign futures broker to be held in the omnibus customer account of the FCM with the foreign futures broker (who deposits the funds in the foreign futures broker's account), the foreign futures broker, by crediting the cash margin to the FCM's omnibus customer account, acknowledges that it controls the funds on behalf of the FCM. Although this account structure does not appear to have been the scenario contemplated by the drafters of the UCC, it is consistent with the analysis of Section 8-106, on which Section 9-104(d)(5) was based, and which has been said to reflect "the general rule that a purchaser can take delivery[359] through another person, so long as the other person is actually acting on behalf of the purchaser or acknowledges that it is holding on behalf of the purchaser."[360]

If the FCM and the customer have agreed to treat such cash margin as a "financial asset" in a "securities account" in respect of which the FCM is acting as securities intermediary and obtaining "control" over that account.[361] The FCM would hold the cash margin in its deposit account at a permitted depository, as described above, and would credit the cash margin to the customer's ~~customer~~ account on the FCM's books.

If the customer and the FCM have agreed to treat the cash margin as a financial asset pursuant to Article 8, then perfection of the FCM's security interest is obtained in the same manner as with respect to security entitlements to margin in the form of securities and cleared ~~swap transactions~~swaps with respect to which a financial asset election has been made. The FCM and the customer would agree that the customer account constitutes a securities account with respect to that asset, and the customer's undivided interest in the FCM's segregated accounts that is credited to the customer's account on the books of the FCM would be the financial asset.[362] If the customer's undivided interest in the FCM's segregated accounts is treated in this manner, then it should not matter whether the FCM holds the underlying funds at a bank depository or at a DCO, and as long as the FCM does not debit the interest from the customer's account, the FCM's interest would remain perfected pursuant to UCC Section 9-314.[363]

~~359 The drafters note here that delivery of a security results in perfection. U.C.C. § 8-301 cmt. 2 (2012).~~

360 N.Y. UCC § 8-301 cmt. 2.

361 *Id.* § 8-102(a)(9)(iii).

362 By treating the cash as a financial asset, the FCM would become subject to the requirements of Part 5 of Article 9, which impose a number of duties upon it as securities intermediary. However, the duties of a "securities intermediary" may be satisfied by acting "with respect to the duty as agreed upon by the entitlement holder and the securities intermediary." *Id.* § 8-505(a)(1).

363 If the cash margin is treated as a financial asset, then the FCM must comply with the requirements of Part 5 of the UCC, which establish the elements of the property interest embodied in a security entitlement to a financial asset. However, "[i]f the substance of a duty imposed upon a securities intermediary by [Part 5] is the subject of other statute, regulation, or rule, compliance with that statute, regulation, or rule satisfies the duty," ~~U.C.C.~~N.Y. UCC § 8-509(a), and the securities

With respect to the security interest of the uncleared swaps affiliate in the cash margin, if the FCM and the customer have made a financial asset election, then the uncleared swaps affiliate's security interest would be perfected by a control agreement or by filing, as described in Section X.B.2 above. If they have not, then the uncleared swaps affiliate may obtain "control" over the cash margin by obtaining the FCM's acknowledgement that it holds the customer's interest in the segregated funds for the uncleared swaps affiliate, subject to its own interest.

4. Uncleared Swaps and Cleared ~~Swap Contracts~~Swaps in the Absence of a Financial Asset Election

As noted above, uncleared swaps are "general intangibles" for purposes of the UCC. Similarly, to the extent that cleared ~~swap contracts~~swaps are not treated as financial assets, the rights of the customer in respect of those contracts would also be general intangibles. To the extent New York law governs perfection of the security interest in these rights, the only method of perfection available is to file a financing statement with the Secretary of State of the State of New York.[364]

With respect to cleared ~~swap transactions~~swaps, if the FCM and the customer have agreed to treat those transactions as financial assets, the uncleared swaps affiliate may nonetheless perfect its security interest by filing, but a security interest in those cleared ~~swap transactions~~swaps that is perfected by control would have priority over a security interest perfected by filing.

XI. CUSTOMER DEFAULT

A. Methods Used to Close Out Customers in Default (~~discussion of main close-out methods~~Discussion of Main Close-Out Methods)

This section addresses the contractual rights of an FCM to close out a customer's ~~cleared customer~~ transactions under the customer agreement between the parties, outside of a customer bankruptcy or insolvency proceeding. The first part addresses a customer's close out of its own positions, in order to establish the basic close-out mechanisms. The second part addresses an FCM's close out of the customer's positions, followed by discussions of cross-product and cross-affiliate liquidations.

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intermediary's obligations are also subject to its rights arising out of a security interest under a security agreement with the entitlement holder or otherwise, and its rights under other law, regulation, rule, or agreement to withhold performance of its duties as a result of unfulfilled obligations of the entitlement holder to the securities intermediary, *id.* § 8-509(c).

364 *Id.* § 9-310(a).

1. Ordinary Course Close Out by Customer

(i) *U.S. Futures ~~Contracts~~*

So long as no customer default has occurred, the FCM acts as the agent of the customer, pursuant to the customer agreement, the CEA and CFTC regulations, and holds the customer's U.S. futures positions and customer funds~~, which are~~ identified in the customer's U.S. futures account with the FCM, and which in turn reflects the customer's beneficial interest in the FCM's ~~customer~~U.S. futures omnibus customer positions account and U.S. futures omnibus customer margin account for U.S. futures with each DCO through which it has cleared the ~~DCO~~customer's U.S. futures positions or delivered the customer's margin, subject to the statutory trust created by Section 4d(a)(2) of the CEA and the related regulations of the CFTC.[365] All U.S. futures transactions are executed on regulated futures exchanges that, in the United States, are registered as designated contract markets ("*DCMs*~~");~~"), and only on the particular DCM that has listed the futures contract being traded. Each DCM clears transactions executed on its exchange through a particular DCO with which the DCM has a clearing relationship. Upon execution of a new transaction (an "*opening transaction*~~")~~") for the customer, the resulting futures contract is credited to the FCM's ~~customer~~U.S. futures omnibus positions account at the DCO, and the FCM records the customer's beneficial interest in that position in the customer's account on the books of the FCM, subject to the customer agreement and CFTC regulations.[366]

This same model is followed in the case of the execution of an order for a "*closing transaction.*" Specifically, open positions may be closed out only by the customer entering an order for execution of an offsetting transaction, and by the FCM's execution of the order as the agent of the customer.[367] The FCM then reports the execution to the DCO in its U.S. futures omnibus customer ~~omnibus~~positions account and updates its position information on file with the DCO, which serves to eliminate the closed-out position.[368] Simultaneously, the offsetting position is credited by the FCM to the customer's account on the books of the FCM. The transaction is then matched with the initial position, which effects a close--out of that position. In this regard, we note that the FCM is required under CFTC and exchange rules to close out offsetting positions, unless otherwise instructed by the client (*i.e.*, in the case of hedging positions).[369]

Upon liquidation of the position, the DCO determines the final variation margin amount that is due in connection with the position from the day prior to the day of

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365 *See generally supra* Section ~~V~~ V.

366 *See, e.g.*, 17 C.F.R. §§ 1.31, 1.32 (2020).

367 *See id.* §166.2 (providing that an FCM may execute transactions for a customer's account only if "specifically authorized" by the customer); CME Rule 540.

368 *See, e.g.*, CME Rules 808.E, 806.

369 17 C.F.R. § 1.46 (2020) (providing that FCMs are required to close out offsetting positions, absent instructions from the customer, such as in the case of hedging transactions). *See also* CME Rule 806.

the closing transaction. That amount is paid to or by the DCO, with the FCM crediting or debiting the customer's account for the appropriate amount. If the customer has instructed the FCM to execute ~~cleared customer transactions~~U.S. futures that are cleared on more than one DCO, this process would be completed with each DCO, resulting in a net amount payable to or from each DCO. In addition, the FCM will decrease amounts credited to, or increase amounts debited from, the customer's U.S. futures account for the amount of any additional charges owed to the FCM under the customer agreement. These may include commissions, transaction fees or administrative fees. To the extent that, as a result of the liquidation of positions, the net liquidating equity in the customer's U.S. futures account is positive, the FCM will credit the appropriate amount to the customer's U.S. futures account. ~~-~~If there is negative net liquidating equity as a result of the liquidations, ~~such~~that amount is owed by the customer to the FCM and the FCM has the authority to liquidate other, non-cash assets in the customer's U.S. futures account in order to cover the amount due.[370]

(ii) *Cleared ~~Swap Contracts~~Swaps*

As noted, U.S. futures ~~transactions~~ may be executed only on the DCMs on which the relevant U.S. futures are listed, and must be cleared through a designated DCO with which that DCM has established a clearing relationship. Swaps that are intended to be cleared, in contrast, can be entered into either by execution on a swaps execution facility (a "*SEF*~~"),~~"), a DCM (although DCMs generally do not currently provide swaps execution services) or in the over-the-counter market. In addition, swaps may be cleared through a variety of DCOs, by mutual agreement between the customer and its FCM clearing broker. Offsetting transactions in cleared ~~swap contracts~~swaps, therefore, are executed and cleared in a different manner than futures.

In particular, a customer seeking to close out a cleared swap ~~contract~~ position in a non-default scenario has a number of alternative mechanisms available to it: (1) execution of an offsetting swap on a SEF (which is not necessarily the same SEF on which the original transaction was executed, provided that the offsetting transaction is submitted to the same DCO for clearing); (2) execution of an offsetting transaction with a bilateral counterparty in the over-the-counter market (where permissible); or (3) a negotiated transfer of the existing swap position to a transferee, which may be (but is not necessarily) the FCM or its affiliate. In each of these instances, the customer would need to report the execution of the offsetting transaction to its FCM clearing broker (unless it is automatically reported by a SEF) and the FCM must accept and submit the offsetting

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370 The "net liquidating equity~~"~~" of a customer's account is defined under CFTC Regulations as an amount equal to the market value of any customer funds that the FCM receives from the customer, as adjusted by (i) any permitted uses of such funds (*i.e.*, permissible investments and charges), (ii) any accruals on permitted investments of such collateral that, pursuant to the FCM's customer account agreement with the customer, are creditable to the customer; (iii) any gains and losses with respect to the customer transactions of the customer; (iv) any charges lawfully accruing to the customer, including any commission, brokerage fee, interest, tax or storage fee; and (v) any appropriately authorized distribution or transfer of such collateral. 17 C.F.R. § 1.20(i) (2020).

transaction for clearing to the same DCO through which the initial transaction was cleared.[371]

Once the offsetting transaction is ~~reported to the FCM and~~ accepted for clearing~~,~~ by the FCM ~~will report~~and the ~~transaction~~DCO, then similar to the ~~DCO in the same manner as would be the~~ case with respect to liquidation of a U.S. futures position~~;~~ ~~*i.e.*, by updating its~~ , the open position ~~information in its~~ of the cleared swap ~~contract~~ in the FCM's cleared swap omnibus customer ~~omnibus~~positions account at the DCO~~.~~ will be offset in its entirety by the offsetting transaction. This will result in the elimination of both the initial cleared swap and the offsetting position, with only a net amount due to or from the customer. As in the case of U.S. futures transactions, the FCM will debit the customer's account for amounts due from it, credit the FCM's cleared swaps omnibus customer ~~omnibus~~margin account at the DCO, and transfer the amount to the DCO. In the case of amounts due to the customer, the DCO will transfer the required amount to the FCM's cleared swaps omnibus customer ~~omnibus~~margin account, and the FCM will credit the customer's account with the FCM.

~~Note, however, that, because~~Because U.S. futures and cleared ~~swap contracts~~swaps are different account classes ~~of transactions~~, this process takes place separately for each of U.S. futures and cleared ~~swap contracts. Note also that~~swaps. In addition, cleared ~~swap contracts~~swaps are subject to the "legally segregated/operationally commingled" ("*LSOC*~~")~~") requirements, which are not applicable to U.S. futures. As a result, with respect to cleared ~~swap contracts~~swaps only, the FCM must record positions, close~~-~~-outs, credits and debits in, and make transfers to and from, the particular sub-account established for each client at the DCO (and not only on the books of the FCM).

(iii) *Foreign Futures*

If the customer has instructed the FCM to execute foreign futures (*i.e.*, the customer is a foreign futures customer), those foreign futures would be closed out in accordance with the practices and procedures applicable to the relevant foreign board of trade and clearing organization, and the contract between the FCM and the applicable foreign futures broker. The process will result in a net amount payable to or from each foreign futures broker, which the FCM would debit from, or credit to, the customer's foreign futures account. This process will be repeated with each relevant foreign futures broker. As in the case of U.S. futures and cleared swaps, the FCM will credit amounts to, or debit amounts from, the foreign futures customer's foreign futures account for the amount of any additional charges owed to the FCM under the customer agreement. The foreign futures broker would utilize margin delivered to it by the FCM on behalf of the foreign futures customer to the extent necessary to close out the contracts and, if that margin is not sufficient, the FCM may utilize the margin held for that particular foreign futures customer in the foreign futures account in the FCM's foreign futures separate

371 *See* CME Rules 808.K, 815.

accounts to satisfy the obligations of the FCM to the foreign futures broker in respect of that customer's foreign futures contracts.

2. Contractual Right of FCM to Close Out upon Customer Default

~~(i) *Futures Contracts*~~

~~Outside of a customer bankruptcy or insolvency proceeding, the~~The FCM's rights in the event of a customer default are determined primarily in accordance with the customer agreement between the FCM and the customer~~ (subject to any applicable requirements or limitations under the CEA or CFTC rules). Typically, the customer agreement grants the FCM the right to close out customer futures positions, and to take other actions that are necessary or appropriate, in the event of a customer default, but does not specify the actions that must be taken.~~, subject to any applicable requirements or limitations under the CEA or CFTC rules and any applicable exchange or clearing house rules, and to any limitations imposed by any applicable insolvency proceedings. The base account agreement contains a section identifying one or more events of default, the effect of which is to give the FCM the right to exercise remedies in respect of the contracts and customer funds credited to the customer account. In general, those defaults include defaults predicated on (i) the customer's filing under applicable bankruptcy or similar insolvency laws, (ii) the filing of a petition for the commencement of involuntary proceedings in respect of the customer under applicable bankruptcy or similar insolvency laws, which filing results in a judgment of insolvency or bankruptcy or an order for relief and (iii) the appointment of an administrator, conservator, receiver or similar official in respect of the customer or all or substantially all of its assets (an "*event of default*"). The CDA provides that a default, event of default or other similar condition or event under the terms of the base account agreement typically gives the FCM the right to exercise remedies in respect of the cleared swaps and cleared swaps customer funds credited to the customer account.

The base account agreement typically provides that upon the occurrence of an event of default, the FCM has the right to, among other things, (1) close out or otherwise liquidate the customer's open positions in its contracts, and hedge risk incurred by the FCM in connection with such event of default, by any reasonable method, including by means of entering into offsetting transactions, risk-reducing transactions or hedging transactions, and by valuing any transactions entered into by the FCM, (2) treat the customer's obligations to the FCM to be due and immediately payable and net or set off any obligations of the customer to the FCM with or against any obligations of the FCM to the customer and (3) sell, liquidate or otherwise dispose of the customer's customer funds consisting of securities and other non-cash assets and apply the proceeds to, or net or set off the value of such proceeds with or against, any amounts due from the

customer to the FCM.[372] The CDA provides the FCM with comparable remedies upon the occurrence of an event of default.

Moreover, under such circumstances, the FCM is no longer required under the customer agreement to follow the customer's instructions and is permitted to act in its own interest, as the legal owner of the positions in the omnibus customer positions account at the DCO or the applicable foreign futures broker, subject to any requirements of the customer agreement (which may require the FCM to act in a commercially reasonable manner).[373] In addition, neither the CEA nor CFTC regulations specifically address actions permitted or required to be taken by an FCM upon a customer default.[374] When a customer defaults (including upon an insolvency), therefore, the FCM may exercise available remedies under the customer agreement and is granted broad discretion as to the actions to be taken. ~~Moreover, as noted previously under such circumstances, the FCM is no longer required under the customer agreement to follow the customer's instructions and is permitted to act in its own interest, as the legal owner of the positions in the omnibus customer account at the DCO, pursuant and subject to the customer agreement (which may require the FCM to act in a commercially reasonable manner).~~[375]

(i) *U.S. Futures*

In general, a close-out of an open futures position by the FCM will be effected in the same manner as described in Section XI.A.1 above, but ~~on~~at the ~~action~~initiative and instruction of the FCM rather than the customer. Specifically, the FCM will enter an offsetting order for the customer's account which, when executed, will liquidate the existing position. The FCM is able to do so ~~in its capacity as the clearing broker and obligor on the customer's positions, with respect~~pursuant to the ~~DCO.~~[376]customer agreement, as described above, and pursuant to DCO rules.[377] The

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372 As used herein, "Margin Liquidation" refers to sale, liquidation or other disposition of the Customer's securities or other non-cash Collateral other than the Customer's Contracts.

373 Similarly, because, as noted, the FCM is permitted under Section 4d(a)(2) of the CEA to apply customer assets to specified obligations of the customer, the FCM is no longer required under the statutory trust to hold and use assets of a defaulting customer solely for that customer, and can take actions with respect to such assets in its own interests and for its own protection.

374 Section 4d(a)(2), while not specifically addressing an FCM's close out of customer positions upon a default, does provide the FCM with the authority to apply customer assets to the satisfaction of the customer's obligations arising from the transactions it has entered into. In particular, Section 4d(a)(2) allows an FCM to commingle and deposit funds in the same account (or accounts) as "shall be necessary to margin, guarantee, secure, transfer, adjust or settle the contracts or trades of such customers, or resulting market positions, with the clearing-house organization of such contract market or derivatives transaction execution facility or with any member of such contract market or derivatives transaction execution facility." 7 U.S.C. § 6d(a)(2).

~~375 Similarly, because, as noted, the FCM is permitted under Section 4d(a)(2) of the CEA to apply customer assets to specified obligations of the customer, the FCM is no longer required under the statutory trust to hold and use assets of a defaulting customer solely for that customer, and can take actions with respect to such assets in its own interests and for its own protection.~~

~~376 *See, e.g.*, CME Rules 806, 811.~~

377 *See, e.g.*, CME Rules 806, 811.

FCM therefore executes the offsetting transactions through its ~~customer~~ omnibus customer positions account with the DCO, which will match executed transactions with the corresponding open positions, resulting in the cancellation of both sets of positions and the determination of any resulting amount ~~that will be~~ due to or from the customer. The FCM similarly credits the resulting positions to the customer's U.S. futures account, which effects a close-~~-~~out of the customer's U.S. futures positions, and determination of any amount due to or from the customer, in the same manner.

Alternatively, the FCM could make a book-entry transfer of the customer's original ~~position~~U.S. futures positions to the FCM's proprietary account, in effect taking over the position itself, extinguishing the customer's beneficial interest in the position and making it a proprietary position, and then execute the offsetting transaction for the proprietary account. In this scenario, the FCM closes out the positions in its proprietary account, transfers to or receives from the DCO the amount due on close-out and credits or debits the customer's U.S. futures account with the FCM for the value of the position transferred to the FCM's proprietary account (which will equal the net amount paid to or received from the DCO). The FCM will also debit the customer's U.S. futures account for the amount of any fees or costs due to the FCM.

~~Because the FCM will be~~ As discussed in Section XI.B.1, in taking ~~the foregoing~~all of these actions ~~in its capacity as the customer's clearing broker, for which it has principal liability to the DCO~~, the FCM is ~~no longer~~not acting as the customer's agent in effecting the close-~~-~~out. Instead, it is acting in its principal capacity, and on its own behalf, in order to protect itself against the liability it will have to the DCO for any unsatisfied obligations it may have with respect to the ~~customer's~~U.S. futures positions it has carried for the customer. This right is granted to the FCM under the customer agreement, the CEA and CFTC rules, and general principles of agency law, all of which permit the FCM to take actions to protect itself following a default.[378]

~~Under the customer agreement, the customer generally grants the FCM a security interest in securities held in the customer's account held in the futures account (and ordinarily the customer funds and positions held in other accounts of the customer at the FCM, and possibly its affiliates), as security for the customer's obligations under the customer agreement. Because the customer's funds and positions are held under a statutory trust in a customer omnibus account at the DCO in the name of the FCM, the security interest granted to the FCM is based on the customer's beneficial interest in the positions and funds rather than in an individual transaction or piece of collateral.~~ In liquidating the customer's futures account in the manner described above, ~~however,~~ the FCM is ~~acting~~relying primarily on its rights, under the customer agreement~~, in exercising~~ and general principles of agency law, to exercise its contractual rights to close out ~~positions and~~ the positions that it had been carrying for the customer, and on the authority granted by Section 4d of the CEA to apply ~~amounts realized to~~ the ~~obligations of the~~customer's U.S. futures customer ~~and~~funds to any Permitted Uses arising out of those

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[378] *See* Commodity Exchange Act, Pub. L. No. 74-675~~,, §~~, § 4d(a)(2), 94 Stat. 1491, 1494 (1936); 17 C.F.R. §1.22 (2020).

positions – not ~~in reliance~~ on ~~its~~the security interest typically granted to the FCM under the customer agreement. However, the FCM ~~could, where appropriate or necessary, particularly~~can also exercise its rights as a secured party with respect to ~~margin deposited by~~ the ~~customer, exercise the FCM's security interest in~~property credited to the customer's U.S. futures account and any other assets of the customer held by the FCM~~.~~ that have been pledged to it to secure the customer's obligations in respect of the U.S. futures account.

Under Section 4d(a)(2), the FCM is permitted to withdraw from the segregated customer funds (to the extent of the customer's balance) relating to the U.S. futures account class any amounts required to pay, or reimburse the FCM for, any Permitted Uses relating to the customer's U.S. futures, thereby reducing the balance in the customer's U.S. futures account. Any losses or amounts due in connection with the customer's U.S. futures account that may not be paid from the segregated funds held for U.S. futures – whether because they are not Permitted Uses or exceed the customer's balance – will be debited from the customer's U.S. futures account, thereby reducing the customer's claim to the segregated assets. Conversely, the FCM will credit to the customer's U.S. futures account any amounts received in respect of the customer's U.S. futures contracts or otherwise due to the customer with respect to those U.S. futures.

In any of the foregoing scenarios, ~~because the FCM continues to act as the agent-trustee of the customer, it~~the FCM is required to account to the customer for any trading gains, and the customer remains liable for any losses, that are realized in connection with the liquidation of positions. ~~As a result, the FCM will credit any positive amounts to the customer's account with the FCM and will debit any negative amounts,~~As the customer's positions are liquidated, the net cumulative gain (or loss) realized with respect to each position in the customer's U.S. futures account, and any related payments to or from that account, will increase (or decrease) the customer's cash balance in the U.S. futures account. Upon the liquidation of the customer's non-cash margin, as the customer's securities and other non-cash assets are liquidated, or the value of such non-cash assets credited to the account is determined, the resulting ~~in an amount due to the FCM.~~liquidation proceeds or values will also increase the cash balance of the U.S. futures account. The ~~FCM can then seek to satisfy any such amounts due from~~ cash balance will also be increased or decreased by other ~~assets of the customer held by the FCM.~~

~~The determination of a customer's net liquidating equity represents a determination of the overall amount due between the customer and the FCM with respect to the customer's futures transactions, rather than the exercise of close-out netting or set off~~applicable credits and debits, including credits in respect of ~~multiple different transactions. This is due to the fact that, as between the customer and the FCM, there are no separate transactions to which the FCM and the customer are the parties; instead, the parties maintain a contractual and statutory trust relationship giving rise to a duty to account under the customer agreement for~~ close-out amounts paid to the FCM's house account and other amounts due to ~~or from~~ the customer~~.~~

~~(ii) *Cleared Swap Contracts*~~

~~In the event~~ and debits in respect of ~~a customer default, if the FCM wishes to exercise a right to~~amounts payable to the FCM, including chargeable costs consisting of reimbursements to the FCM for close~~-out~~-out amounts paid by the FCM with its own funds to third parties and other costs and expenses incurred in connection with the FCM's exercise of remedies.[379]

Consistent with the intention of the parties that the account represent a single, indivisible mutual open and running account, the debits and credits would result in a single balance at any time. However, if, for some reason, the intention of the parties is not honored, the determination of the cash balance of the customer account could be viewed as involving netting or setoff of the FCM's obligation to account for the net gains on the customer's contracts against the customer's obligations to the FCM under the customer agreement. On this theory, the realization of cumulative trading gains and losses upon the liquidation of the customer's positions could be viewed as the determination of the respective obligations of the FCM to pay the trading gains and any other profits derived from its activities on behalf of the customer under the customer agreement against the obligations of the customer to indemnify the FCM against any trading losses or other costs or losses incurred in carrying out that activity. Additionally, deducting any net cumulative loss realized in the liquidation of the customer's positions ~~of the customer, it generally does so~~could also be viewed as reflecting a setoff of the FCM's obligation to repay to the customer the cash balance of the account (which may include net cumulative gains realized in the liquidation of positions and proceeds from the liquidation of the customer's non-cash margin) against the customer's obligation to pay the FCM an amount equal to any net cumulative losses as well as any chargeable costs.

The FCM will determine a single cash balance for the U.S. futures account based on these debits and credits. A negative cash balance will constitute a debit balance payable by the customer to the FCM. A positive cash balance will constitute a credit balance payable by the FCM to the customer.[380]

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379 Any proceeds received from a DCO or other parties for the benefit of the customer in connection with the liquidation of the customer's positions, and any such proceeds received in connection with the liquidation of the customer's margin, must be held in accordance with the customer property rules. as discussed in Section VI.B, the customer property rules expressly permit the FCM to withdraw and apply such funds to Permitted Uses, including to guarantee, transfer and settle the customer's transactions.

380 The events of default and remedies section in a Base Account Agreement will typically not specify how the cash balance is calculated when the Customer's Futures Account is liquidated (because the process for that calculation would presumably be part of the operation of the account inferred from the course of dealing between the parties prior to the Customer's default, industry practice and applicable law, including the margining standards). *See* Section IV.D.

(ii) *Cleared Swaps*

In closing out a customer's cleared swaps positions as a result of the customer's default, the FCM acts on the same legal basis as described above with respect to U.S. futures~~;~~ contracts, *i.e.*, exercising its rights under its customer agreement~~, as modified in the case of swaps by the Cleared Derivatives Addendum~~ arising upon the occurrence of an event of default, as modified in the case of swaps by the CDA.[381] However, because swaps are executed in a manner that ~~is distinct in material respects~~differs significantly from U.S. futures, the ~~mechanics of~~process by which the ~~FCM's execution of~~FCM executes an offsetting transaction with respect to a cleared swap ~~contract will~~ does not follow the futures model.[382] In particular, ~~as noted,~~ because all U.S. futures are executed on a DCM, through a U.S. futures omnibus customer ~~omnibus~~positions account of an FCM carrying a particular customer's account, the FCM can close out a customer's position simply by entering an offsetting order through ~~its~~that omnibus customer ~~omnibus~~positions account (which it has the authority to do under its agreement with the customer). ~~Because~~In contrast, because swaps are executed either through SEFs or in the over-the-counter market,[383] and because the FCM most likely will not have the authority to execute an offsetting swap on behalf of the customer on a SEF or with a bilateral counterparty, the FCM will likely be required to transfer the customer's open swap position to the FCM's ~~house~~proprietary account at the DCO, where it can execute an offsetting cleared swap as principal (on a SEF or over-the-counter) and offset ~~such~~that new cleared swap against the original cleared swap.[~~384~~]

The ~~Cleared Derivatives Addendum~~CDA provides the FCM with the right to designate a liquidation date and to close out cleared swap ~~contract~~ positions in any one of a number of ways, at the election of the FCM. ~~First, the~~The FCM would most likely

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381 Note that Section 4d(f)(2) of the CEA provides an FCM with authority over a customer's assets held in connection with cleared swaps that is analogous to the authority granted with respect to futures under Section 4d(a)(2). Specifically, Section 4d(f)(2) permits an FCM to withdraw from the customer omnibus account (and thereby to debit the customer's account on the FCM's books) amounts necessary to satisfy the customer's obligations in connection with its cleared swap transactions.

382 The rights and obligations of an FCM with respect to a cleared swaps customer's account and assets are similar to those discussed above with respect to futures, and are set forth, in addition to the customer agreement, in Part 22 of the CFTC's rules.

383 7 U.S.C. § 2(h)(8)(A)(ii), (B)

~~384 Section 8(a)(vi) of the Cleared Derivatives Addendum provides that, "[i]n connection with determining the termination amount payable to this Section 8(a), Client agrees that Clearing Member may take any action that is required under the relevant Rule Set for the purpose of Transferring the related CM/CCP Transactions from the relevant Client Account to Clearing Member's proprietary account." The FCM enjoys this power even if a contract is not terminated pursuant to default: "Where any Client Transaction . . . is terminated early pursuant to this Addendum [outside of default] . . . in connection with any such termination, Client agrees that Clearing Member may take any action that is necessary under the relevant Rule Sets for the purpose of Transferring the related CM/CCP Transactions from the relevant Client Account to Clearing Member's proprietary account." FIA-ISDA Client Cleared OTC Derivatives Addendum, § 9(d).~~

effect this liquidation either by executing the offsetting ~~transactions for~~cleared swaps in its proprietary ~~(house) omnibus~~ account at the DCO and then transferring the resulting positions to its cleared swaps omnibus customer ~~omnibus~~positions account at the DCO, or by transferring the defaulting customer's cleared swaps positions to its proprietary account and executing the offsetting transactions in its proprietary account. In either event, the offsetting positions will automatically terminate the original positions. The FCM would then ~~calculates~~calculate the gain or loss on the positions deriving from the liquidation, together with any costs, and ~~credits~~credit or ~~debits~~debit the customer's account by the net open trade equity of the transactions. The FCM can then determine the overall net liquidating equity of the customer's cleared swaps account.

~~Second, the~~The FCM may also enter into sale or novation transactions with respect to the cleared swaps positions to be closed out~~,~~ by selling or novating the positions to a third party, which will thereby assume all or part of the rights and obligations of the customer~~.~~, or to its own proprietary account, in which case the FCM itself will assume those rights and obligations for its own account. The purchaser of the cleared swaps positions will pay to or receive from the FCM ~~(~~for credit to or debit from the customer's ~~account~~cleared swaps account (or the FCM itself will credit or debit the customer's cleared swaps account for) an amount equal to the net value of the cleared swaps positions it acquires, and the cleared swaps positions will be debited from the defaulting customer's cleared swaps account at the FCM. The FCM then calculates the net liquidating equity of the defaulting customer's cleared swaps account, taking into account the amount paid or received on the sale of the positions. If ~~such~~that amount is positive (a credit), the FCM will ~~pay~~owe such amount ~~into~~to the ~~account~~customer. Conversely, if the amount is negative, that amount is ~~paid or~~ owed by the customer to the FCM. The cleared swaps positions are then credited to the purchaser's account at the FCM, or at another FCM that is a clearing member of the DCO through which the positions were cleared. If the positions are credited to an account of the purchaser at the same FCM, there is no change in the open position in the cleared swaps omnibus customer ~~omnibus~~positions account of the FCM at the DCO. If, on the other hand, the positions are transferred to another FCM, the original FCM's cleared swaps omnibus customer ~~omnibus~~positions account at the DCO will be debited and the new FCM's cleared swaps omnibus customer ~~omnibus~~positions account will be credited with the positions transferred.

Third, the FCM can enter into replacement transactions for its cleared swaps proprietary account, by terminating the ~~transactions~~cleared swaps to be closed out (and debiting the positions from the FCM's cleared swaps omnibus customer ~~omnibus~~positions account at the DCO) and establishing new positions, on identical terms, for its proprietary account and crediting its proprietary account at the DCO accordingly. The FCM then typically closes out the replacement transactions by entering into offsetting transactions ~~for~~in its proprietary account. As in the case of the sale/novation alternative, the FCM then calculates the gains or losses resulting from the replacement and offsetting transactions, as well as associated costs, debits or credits the appropriate amount from or to the customer's ~~account and determines the net liquidating equity of the account. The FCM pays any positive amount to the account and the customer pays or~~

owes any negative amount to the FCM. As noted with respect to the alternatives outlined above, the FCM takes these actions on its own behalf, as principal for its proprietary account, and not as the agent of the customer, in order to protect itself from greater liability to the DCO for the default of the customer.[385] However, because the FCM remains the agent-trustee of the customer, it is required to account to the customer for profits or losses on the transactions. Note also that, incleared swaps account and determines the net liquidating equity of the cleared swaps account.

In any of these scenarios, the FCM might enter into hedging transactions for its proprietary account at the DCO, in order to protect itself from further losses (for which it would be liable to the DCO) arising from fluctuations in the value of the positions being closed out during the period of time required to complete the liquidation.

Therefore, once all positions in the customer's account have been liquidated, the FCM calculates the final net liquidating equity of the account. This amount reflects the overall position between the FCM and the customer in terms of the FCM's role as agent and under the statutory trust for the customer. Under the terms of the customer agreement and the statutory trust, the FCM is permitted to withdraw from the account, and pay to itself, any amounts due to it (to the extent that they constitute permitted costs under the customer agreement and the CEA). Any losses or amounts due in connection with the customer's account or transactions that are not permissible will be debited from the customer's account. Conversely, the FCM is obligated to credit to the account any amounts due to the customer and remains entitled to the residual financial interest. The determination of a customer's net liquidating equity in its account in effect establishes the overall position between the FCM and the customer under the statutory trust in accordance with the customer agreement. This represents a determination of the overall value of the customer's account and the obligations between the FCM and the customer, rather than the exercise of close-out netting or set off in respect of a number of different transactions. Close-out netting or setoff is not required since, as between the FCM and the customer, there are no distinct transactions or obligations that are separate from the overall contractual and trust relationship giving rise to a duty to account either way between the customer and the FCM that is evidenced by the customer agreement.

In addition, as described above with respect to the futures account, the customer generally grants the FCM a security interest in securities held in the cleared swaps account (and other accounts at the FCM), as security for the customer's obligations under the customer agreement. Upon a default by the customer and the determination of the amount due to the FCM or the customer, therefore, the FCM can exercise its security interest and apply assets in each of the customer's accounts, in accordance with the customer agreement and the UCC, to any amounts due to the FCM that are not satisfied

[385] The Cleared Derivatives Addendum places certain limited restrictions on the FCM, including requiring that the FCM act in good faith and in a commercially reasonable manner. *See* Cleared Derivatives Addendum § 7.

~~by the amounts available in the customer's account.[386] However, as is the case with respect to liquidation of futures positions, in liquidating the customer's cleared swaps account, the FCM is acting primarily under the customer agreement, as modified by the Cleared Derivatives Addendum, as described above, in exercising its contractual rights to close out positions and apply amounts realized to the obligations of the customer.~~

~~This is due in large part to the fact that the statutory trust created in respect of the segregated funds expressly permits the FCM to withdraw and apply the segregated funds for the purposes established by the statute. In doing so, the FCM is not foreclosing on or enforcing security over property of the customer or, indeed, exercising any form of legal set off, but rather the FCM is applying the segregated funds that it holds in the statutory trust created for this purpose in accordance with the terms of the statutory trust to produce a net amount. Consistent with the terms of the statutory trust, the FCM is required to account to the customer for the outstanding balance of the customer account and remains entitled to the FCM's own residual interest in the segregated account, which it may withdraw for its own account provided that this does not cause the FCM's residual interest to fall below its targeted level.~~

~~Following an event of default relating to the customer, the FCM is also entitled to enforce the security interest over the customer's beneficial interest under the statutory trust and to~~As noted with respect to U.S. futures above, the FCM takes all these actions on its own behalf, as principal for its own account, and not as the agent of the customer, in order to protect itself from greater liability to the DCO for the default of the customer.[387] However, the FCM is required to account to the customer for the profits or losses on the customer's position.

As in the liquidation of the customer's U.S. futures, as the customer's positions are liquidated, the net cumulative gain (or loss) realized with respect to each cleared swap position in the customer's contracts, the liquidation proceeds or values relating to the non-cash margin of the customer, any related payments to or from the account, and any other applicable credits and debits will increase (or decrease) the cash balance in the customer's cleared swaps account, and the FCM will determine a single cash balance for the cleared swaps account based on these debits and credits.[388]

~~386~~ ~~The Cleared Derivatives Addendum provides, if the parties so elect: "Client agrees that Clearing Member may use any collateral provided by Client under a Collateral Agreement in respect of Client Transactions in order to allow Clearing Member to satisfy Clearing Member's obligations to provide collateral to the relevant Agreed CCP in connection with such Client Transactions." FIA-ISDA Client Cleared OTC Derivatives Addendum, § 10(b)(i).~~

387 The Cleared Derivatives Addendum places certain limited restrictions on the FCM, including requiring that the FCM act in good faith and in a commercially reasonable manner. *See* Cleared Derivatives Addendum § 7.

388 Section 7 of the CDA, which covers Events of Default and remedies, sets out how a "net termination amount" would be calculated. However, as noted *supra* note 380, the customer agreement will typically not specify how the cash balance is calculated when the Customer's Futures Account is liquidated.

Again, although the FCM has a security interest in the customer's cleared swaps account following the customer's default, the FCM typically relies principally on its contractual rights and its rights under Section 4d(f), as described above. However, the FCM may also exercise its rights as a secured party security interest enforce its security interest over the customer's cleared swaps account and the property held in the account, as well as any other collateral that the FCM may have, and thereby realize the value of the customer funds held in the segregated funds account. In doing so, the FCM ~~is~~would be exercising its rights of disposition of collateral provided for under the UCC, although this involves largely the same steps described above.

~~Just as with futures transactions described above, the determination of a customer's net liquidating equity represents a determination of the overall value of the customer's positions in cleared swaps, rather than the exercise of close-out netting or set off in respect of multiple different transactions. Close-out netting or setoff is not required because, as between the customer and the FCM, there are no separate transactions or obligations distinct from the overall contractual and statutory trust relationship giving rise to a duty to account either way between the customer and the FCM as evidenced by the customer agreement.~~

(iii) *Foreign Futures*

In the event of a customer default, if the FCM wishes to exercise a right to close out foreign futures contracts of the customer, it generally does so on the same legal basis as described above with respect to futures contracts, *i.e.*, by exercising its rights under its customer agreement, the applicable agreement with the relevant foreign futures broker, and the rules of the applicable foreign board of trade and clearing organization. In doing so, the procedure would be similar to the process described in Section XI.A.1(iii) above. The process will result in a net amount payable to or from each foreign futures broker, which the FCM would debit from, or credit to, the customer's foreign futures account. This process would be repeated with each relevant foreign futures broker. In addition, as in the case of futures contracts, the FCM will credit amounts to, or debit amounts from, the customer's foreign futures account for any additional charges owed to the FCM under the customer agreement in respect of the customer's foreign futures positions or the liquidation process relating to them. The foreign futures broker would utilize margin delivered to it by the FCM on behalf of the foreign futures customer to the extent necessary to close out the contracts and, if that margin is not sufficient, the FCM would utilize the margin held in its foreign futures separate account to satisfy the obligations of the FCM to the foreign futures broker in respect of the foreign futures customer's foreign futures positions.

3. Cross-Product Liquidation

~~The customer agreement between an FCM and its customer, together with the Cleared Derivatives Addendum, may, and typically would, also grant to the FCM, upon a default by the customer, cross-product liquidation rights, across account classes that are maintained under the same customer agreement. As noted above, futures~~

contracts and cleared swap contracts are required to be maintained in separate customer omnibus accounts at the DCO and may (but are not required to) be maintained in separate customer accounts at the FCM. In any event, they are treated as separate account classes. The FCM is typically authorized under the customer agreement to declare a default in one account or account class, and close out positions in such account, upon a default with respect to the other account or account class.

If an FCM has and exercises the right to effect a cross-product liquidation, it will generally do so in the same manner described above within each account class. Specifically, upon a default with respect to the customer's futures positions, the FCM would have the right to declare a default in the customer's futures account and to take the actions described above with respect to the close out of the customer's open futures positions, determination of a net amount owed to or from the customer, the crediting or debiting of the customer's account and the calculation of the resulting net liquidating equity of the account class. In addition, the FCM can declare a default with respect to the same customer's cleared swaps account (or account class), regardless of whether a default has occurred in connection with the cleared swaps account, and to close out the cleared swap contracts positions as well. The close out of open cleared swap contract positions would also be effected in the manner described above, through offsetting cleared swap contracts, sale/novation or replacement, the termination of open positions and the determination of the net amount, reflected in the net liquidating value of the cleared swaps account.

Upon the liquidation of positions in each account class of cleared customer transactions, at the DCO level, variation margin accrues for the last trading day the position is open, which is calculated after the close of business of the trading day and then settled between the DCO and FCM before open of business or at open of business, depending on the DCO, the next trading day, which results in either a debit or credit to the FCM's segregated account at the FCM's settlement bank. As noted above, any funds from a customer transaction are held in an FCM's account at its DCO, which is an omnibus account that includes funds from other FCMs. Additionally, when funds received from DCOs in respect of variation margin on a customer's customer transactions are deposited in the FCM's segregated account maintained with the FCM, the FCM credits the open trade equity balance of the customer's customer account at the FCM by the relevant amount accruing to such customer and when funds are withdrawn from the FCM's segregation account by a DCO in respect of variation margin on a customer's transactions, the FCM debits the open trade equity balance of the customer's customer account with the FCM by the relevant amount. The FCM and the DCO would each net the amounts due to or from the FCM's omnibus customer margin account in each account class separately and determine an overall net amount due for each of futures and swaps transactions.[389] The FCM would credit or debit the customer's account with the appropriate amount and calculate the net liquidating equity of each account class and will

[389] Because the DCO transacts only with the FCM and not with the customer, the DCO will calculate a single net amount due (for each account class) and the FCM will, in turn, distribute the appropriate debits and credits among its customers.

~~calculate an overall, single credit or debit balance for the customer. The DCO will similarly credit or debit the FCM's omnibus customer position account at the DCO and the FCM will satisfy any amounts due from the customer's account(s), while crediting any amounts received from the DCO to such accounts. If the FCM carries customer positions at multiple DCOs, the FCM will go through this same process separately at each DCO.~~

~~As noted above, the customer agreement will ordinarily also grant the FCM a security interest in all of its accounts with the FCM, to secure its obligations under any such account and the FCM would therefore have the right to satisfy the customer's obligations through the exercise of its security interest. Moreover, even without an express cross-default right between the customer's futures and cleared swaps accounts or sub-accounts, the security interest in each account allows the FCM to accomplish the same objective.~~

~~Following the liquidation of all transactions pursuant to the relevant methods set out in Section XI.A.2 above (as applicable), a single net amount is determined by the FCM, representing the final net liquidating equity of the customer's account for cleared customer transactions, and if the customer transacts in foreign futures, foreign futures as well.~~If the customer's account includes only one account class, then there is only a single determination of account for that account class. If the customer's account includes multiple account classes, then a final cash balance will be determined for each account class and, unless the customer agreement provides otherwise, the FCM will then aggregate or offset the credit balances or debit balances of all account classes to determine a single aggregate credit or debit balance in respect of the customer account.

Consistent with the status of the customer account as a mutual open account, it is the intent of the FCM and its customer that the individual debits and credits in the account represent a connected series of entries of reciprocal charges and allowances that are not to be considered independently but rather as a continuation of a related series generating a running balance, and that upon the liquidation and closing of the account, the final cash balance in the account constitutes a single indivisible debt claim by one party against the other, as discussed in Section IV.B above. Accordingly, the FCM's determination of the final account should be viewed as merely an accounting procedure to ascertain what that debt claim is, by calculating the result of applying the debits and credits made to the customer's account cash balance over time, rather than the setoff of independent obligations to bring about a single debt claim. This characterization would apply both to the calculation of the final cash balance for each account class within a customer account, and to the calculation of the final cash balance for all the account classes on a combined basis. In other words, the determination of the final balance of the customer account is the result of calculating the running account balance of all debits and credits made to the account over its life, which is a determination of the overall value of the single course of dealing between the FCM and the customer represented by the account, rather than the setoff of distinct claims arising under separate transactions

between the FCM and customer corresponding to the transactions carried in the account.[390]

To the extent that a customer has a negative cash balance with respect to any account class, that negative cash balance would reduce the customer's aggregate account balance across all account classes; to the extent the customer has a positive cash balance with respect to any account class, the customer would have a right to the corresponding balance of assets held under the customer property rules with respect to that account class. However, the customer agreement typically provides that the balances across all the accounts and subaccounts within the customer's overarching account will be aggregated to reach a single balance.

The aggregation of the account balances across account classes may, at first blush, appear to contravene the terms of the CFTC's customer property rules providing that customer funds relating to an account class cannot be used to satisfy obligations with respect to any other account class. However, as the CFTC explained in Financial and Segregation Interpretation No. 14, an FCM may charge a customer's account for an account class for charges that do not constitute Permitted Uses that may be paid directly from the funds held in segregation or in a foreign futures separate account.[391] If the FCM does so, the charge results in a debit to the balance in that account, reducing the FCM's liability to the customer, and in turn reducing the customer's claim against the assets held under the customer property rules.[392] If the customer authorizes the FCM to offset all amounts due to and from the FCM and the customer under the customer agreement, the FCM may thereby reduce the customer's claim against the FCM in respect of the account or subaccount relating to one account class by the amount that the FCM owes the customer in respect of another.

The determination of the aggregate balance in the customer's account may also be characterized as a setoff of the balances determined in respect of the respective account classes. The customer agreement will ordinarily grant the FCM both a right to set off all amounts owed by the customer to the FCM under the customer agreement against all amounts owed by the FCM to the customer, and a security interest in all of the customer's accounts with the FCM, to secure its obligations under any such account. The FCM would, as a result, have a contractual right of setoff allowing it to offset any negative net liquidation amount in respect of one account class against a positive net

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390 Because of the way in which the customer property rules operate, as described in Sections IV.B and VI.B above, the final cash balance of a customer's account relating to an account class also represents the overall position between the FCM and the customer with respect to the segregated funds or foreign futures separate amount under the applicable customer property rules, and the balance reflects the results of the FCM's withdrawal and application of the segregated funds or separate account funds for Permitted Uses in connection with the liquidation of its positions. In applying the segregated funds or foreign futures separate amount, the FCM is not foreclosing on or enforcing its security interest, or exercising setoff, but rather is acting pursuant to express authority granted it under such customer property rules.

391 See *supra* text accompanying note 119.

392 Financial and Segregation Interpretation No. 14, *supra* note 135.

liquidation amount in respect of another account class, as well as the right to exercise its remedies as a secured party to apply the proceeds of any account class against any unpaid amounts arising in respect of any other account class.

It can be argued that the CEA not only permits but even requires any excess customer funds held in segregation for one account class to be applied to any other account class in the context of a customer default. In the past several years, the CFTC has emphasized the critical importance of CFTC Rule 1.56, which prohibits an FCM from guaranteeing its customers against losses arising from trading, in protecting markets and customers generally from fellow customer risk. By prohibiting the practice of guarantees against loss, "the Commission endeavored to enhance the safety of customer funds, promote orderly resolution and transfer of open customer accounts in the event of an FCM's bankruptcy, and avoid any practice which jeopardizes the segregation requirements prescribed in Section 4d(a)(2) of the Commodity Exchange Act (the "CEA")."[393] In making this statement, the staff identified Rule 1.56 as one of its "regulations concerning the protection of customer funds," suggesting that Rule 1.56 could be viewed as one of the regulations establishing the terms of the specific statutory trusts relating to futures contracts, foreign futures contracts, and cleared swap contracts.[394]

Moreover, in the context of customer liquidation, the CFTC has noted that "in the futures context, the 'Commission and court precedent have long held that when an FCM determines that a customer is under-margined, the FCM's duty to protect the financial position of the FCM's other customers and right to protect the FCM's own financial position can supersede any duties the FCM owes to the under-margined customer.'"[395] In one order, the CFTC went so far as to say that:

> when a customer fails to pay a margin call, an FCM's duty to protect the financial position of its other customers and its right to protect its own financial position supersedes *any* duties it owes to the defaulting customer. In these circumstances, the Commission permits FCMs to make

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393 Advisory and Time-Limited No-Action Relief with Respect to the Treatment of Separate Accounts by Futures Commission Merchants, CFTC Letter 19-17 (July 10, 2019), *available at* https://www.cftc.gov/node/217076.

394 The terms of the specific statutory trust are determined by the regulations under which it is created. *See, e.g.*, *Marchese* v. *Shearson Hayden Stone, Inc.*, 822 F.2d 876, 878 (9th Cir. 1987) (concluding that the terms of the statutory trust are subject to CFTC regulations). If Rule 1.56 is a regulation governing the specific statutory trust, then its prohibition against guaranteeing against loss would be a term of the statutory trust, potentially overriding the prohibition on utilizing the segregated assets once all obligations of the customer in respect of contracts in the applicable account class have been satisfied.

395 *Whited* v. *E*Trade Futures LLC*, Initial Decision & Order Dismissing Complaint and Awarding Counterclaim, CFTC Dkt. No. 18-R030 (Mar. 26, 2020), *available at* https://cftc.gov/sites/default/files/2020/03/Idwhited03-26-2020.pdf.

> good faith judgments about the steps necessary to protect its financial interests. . . . We believe that an FCM's duty under Section 4d is also conditioned when it exercises its right to close the account of a current customer.[396]

Although these references to Section 4d related to the FCM's obligation to comply with customer orders, rather than its obligation to segregate assets, they indicate the potential that the prohibition on guarantees against loss in Rule 1.56 may be at least as fundamental as the customer segregation requirements. When adopting Rule 1.56, the CFTC noted that segregation is a critical aspect of the customer property rules established by the CEA but also noted that "[e]qually basic to the overall statutory scheme is that FCMs must at all times be in compliance with the financial requirements prescribed by the Commission,"[397] leading the CFTC to prohibit FCMs from incurring the risks that would result from limiting customer losses. Because Rule 1.56 would override the segregation requirements only when the customer has defaulted and excess margin remains, other customers should not be placed at risk if the FCM applies excess from one account class of the defaulted customer to obligations remaining in respect of another account class or classes of that defaulted customer.[398]

We have not identified any statements by the CFTC directly supporting this interpretation of the interaction between Rule 1.56 and the customer segregation requirements. However, given the application of Financial and Segregation Interpretation No. 14, it may not be necessary to rely upon Rule 1.56 as well.

4. Cross-Affiliate Liquidation

The same customer that has established a futures account and a cleared swaps account with an FCM may also have entered into a master agreement or other swap trading documentation with an uncleared swaps affiliate of the FCM, pursuant to which the customer and the uncleared swaps affiliate may enter into uncleared, over-the-counter swaps as principal (with respect to swaps not subject to a mandatory clearing requirement). This will typically be the case where the uncleared swaps affiliate is a registered swap dealer engaged in a regular business of entering into principal-to-principal transactions with counterparties. The uncleared swaps affiliate may enter into swaps with the customer that are not subject to the mandatory clearing requirement. In that case, the positions simply remain as open bilateral positions between the customer and the uncleared swaps affiliate, but may still be subject to a cross-affiliate liquidation right. In order to create this right, the FCM, uncleared swaps affiliate and customer may have entered into a tri-party agreement providing the FCM and uncleared swaps affiliate

396 *Lee* v. *Lind-Waldock & Co.*, Opinion and Order, CFTC Docket No. 99-R018 (June 29, 2000) (emphasis added), *available at* https://www.cftc.gov/sites/default/files/ogc/oporders00/ogclee062900.htm.

397 Prohibition of Guarantees Against Loss, 46 Fed. Reg. 62,841, 62,843 (Dec. 29, 1981).

398 Indeed, as noted above, the FCM would have the right to debit the customer account for any amounts due in respect of the other account class, thereby reducing the customer's claim to the segregated assets, which would have the same effect as interpreting Rule 1.56 as described above.

with the right to declare a default under each entity's respective agreement with the customer upon the occurrence of a default under the customer's agreement with the other entity. Alternatively, where no tri-party agreement is in place, it is possible that the customer, in its separate agreement with each of the FCM and the uncleared swaps affiliate, has granted each such entity the same type of cross-default right (although, in that situation, the FCM and uncleared swaps affiliate may need some agreement between themselves regarding the management of a default and close out, allocation of assets and other matters).

The FCM would exercise the cross-affiliate liquidation right in the same manner described above, with respect to the customer's futures contract positions and cleared swap ~~contract~~ positions. Specifically, the FCM would, upon a default by the customer under its agreement with the uncleared swaps affiliate, have the right to close out futures positions in the customer's account through offsetting transactions in the manner set forth above. Conversely, upon a default in the customer's futures account with the FCM, the uncleared swaps affiliate would have the right to treat the default as a cross-default and close out its swaps positions with the customer, through offsetting transactions entered into by the uncleared swaps affiliate as principal. The FCM will be dependent on the uncleared swaps affiliate to effect a close-out or a transfer of the positions to the FCM. This arrangement would need to be covered in a tri-party agreement among the customer, FCM and uncleared swaps affiliate, or in a bilateral agreement between the FCM and uncleared swaps affiliate. The uncleared swaps affiliate will close out the uncleared swaps positions by transferring the customer's positions to its proprietary account, entering into offsetting swaps in the over-the-counter market for its proprietary account, and matching those positions with the customer's open swap positions, which will terminate the positions and allow the uncleared swaps affiliate to calculate a net amount due to or from the customer.

As discussed above, the customer typically also grants the FCM or uncleared swaps affiliate a security interest in the customer's rights in its account and its agreement with the other entity, including assets in its account with the other entity, amounts due to it from the other entity and positions held for it by the other entity. Upon the declaration of a default by the FCM or uncleared swaps affiliate, the entity declaring the default would have the right to exercise the security interest in order to satisfy any shortfall in amounts owed to it by the customer as a result of the default. Even if no default has occurred in one of the accounts, therefore, the FCM or uncleared swaps affiliate, as the case may be, would have the right to exercise its security interest in the non-defaulted account, foreclose on the account in accordance with the UCC, liquidate the assets in the account and apply the proceeds to the satisfaction of any amounts due to it by the customer. For a discussion of the mechanisms required to perfect such a security interest, see Section X above. However, in this scenario as well, and as discussed above, the FCM typically takes action against the customer's position and account on a contractual basis, rather than through exercise of its security interest.

B. Capacity of the FCM in Closing Out a Defaulting Customer

1. Whether the FCM Acts as the Customer's Agent in Closing Out the ~~Cleared Customer~~ Transactions and Foreign Futures ~~Contracts~~

Although the FCM's right to take the actions described in Sections XI.A.2, XI.A.3 and XI.A.4 above arises out of the same contract that establishes the agency relationship between the FCM and the customer (the customer agreement), the FCM does not take these actions as the customer's agent. Rather, the FCM exercises the contractual rights given to it in the customer agreement, and under common law, custom and usage, to protect itself from the liabilities and losses that it would otherwise suffer as a result of acting as the customer's agent. No longer subject to the obligation to act only at the direction of the customer, the FCM exercises its rights as the party in privity with the DCO under the customer transactions (and the attendant termination rights as provided under the DCO's rules)[399] for its own benefit and at its own direction.[400]

An essential element of any agency is that the agent is subject to the control of the principal. As discussed in Section VI.A above, an agency exists "when one person (a 'principal') manifests assent to another person (an 'agent') that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act."[401] When an agency relationship exists, it is a fiduciary relationship, the scope of which depends on any relevant contract, custom and usage and applicable law. Thus, the ability of the principal (here, the customer) to control the actions of the agent, and the agent's fiduciary obligations to that principal, are the hallmarks of the agency relationship.

The obligation to follow the principal's instructions is the critical characteristic of the agency relationship whether or not the word "agent" is used in the contract. "[E]ven though one may be an agent for some purposes, if an alleged agent's acts concerning a certain subject matter cannot be controlled and directed by the principal, there is no agency relationship with regard to that subject matter."[402] As noted in Section IV above, we have assumed that each customer agreement requires the FCM to comply with the customer's instructions with respect to the customer account and the customer transactions, unless and until the customer defaults – but gives the FCM, acting alone, the power to terminate and liquidate the customer account and customer transactions after a customer default, without any instruction or control from the

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399 *See, e.g.*, CME Rule 930.K.

400 Although the FCM does have a security interest in the customer's beneficial interest in the customer transactions, the FCM's exercise of its contractual rights is not a foreclosure upon the customer's beneficial interest, but rather the exercise of its contractual rights.

401 RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006).

402 *In re Drexel Burnham Lambert Grp. Inc.*, 113 B.R. 830, 841-42 (Bankr. S.D.N.Y. 1990) (citations omitted); *accord In re LFD Operating, Inc.* v. *Ames Dep't Stores, Inc.*, 274 B.R. 600 (Bankr. S.D.N.Y. 2002).

customer. Accordingly, in carrying out that process, the FCM is not acting as the customer's agent.[403]

Furthermore, in addition to making clear that the customer does not control the liquidation process, the customer agreement clearly authorizes the FCM to take action with respect to the customer transactions following the customer's default in a manner that may be adverse to the customer. This type of action would, in the absence of the customer's consent, violate the duty of an agent "not to deal with the principal as . ~~.~~ . . an adverse party in a transaction connected with the agency relationship."[404] The FCM, in closing out, liquidating or taking similar action with respect to any customer transaction carried by the FCM for that customer, is exercising its right to protect its own interest, regardless of the customer's wishes, based on the prior consent of the customer contained in the customer agreement. This too makes clear that the FCM is not acting in its capacity as agent, because, "to the extent that an agent is privileged to take action to protect the agent's own interests . ~~. .~~ . . , the agent's action is not that of an agent."[405]

Even without the express authorization contained in the customer agreement, the Restatement (Second) of Agency provides that:

> An agent whose principal violates or threatens to violate a contractual or restitutional duty to him has an appropriate remedy. He can, in a proper case:
>
> (a) maintain an action at law;
>
> (b) obtain a decree for an accounting or other equitable relief;
>
> (c) maintain a claim to a set-off or a counterclaim in an action brought by the principal;
>
> (d) refuse to render further services;
>
> (e) exercise the rights of a lien holder; or

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403 Accordingly, the FCM's performance under the contract would be subject to the implied covenant of good faith and fair dealing that is part of every contract governed by New York law, but would not be subject to the duties of an agent. As noted above in the text accompanying note ~~25~~88, it is possible for a single agreement to provide for both an agency relationship and a contractual relationship that does not involve agency.

404 RESTATEMENT (THIRD) OF AGENCY § 8.03 (2006).

405 *Id.* § 8.06 cmt. b; *see also id.* § 8.01 cmt. c ("Contemporaneously with a relationship of agency, a principal and an agent may have additional legal relationships that do not subject either to a fiduciary duty to the other. For example, an agent may have a right to assert a lien over property of the principal to secure the amount of compensation due the agent from the principal.").

(f) stop in transit goods shipped to the principal.[406]

The CFTC's guidance also supports the conclusion that an FCM is permitted to exercise contractual rights for its own protection following a customer default. The CFTC has recognized through administrative law decisions that, upon a customer's default, the FCM may take the protective steps it deems necessary in the exercise of its good faith business judgment.[407] "Protective steps" generally include the liquidation of the customer's open positions.[408] In addition, Congress adopted the amendments to the Bankruptcy Code permitting liquidation of commodity contracts upon the bankruptcy of the customer because "[t]he prompt closing out or liquidation of such open accounts freezes the status quo and minimizes the potentially massive losses and chain reactions that could occur if the market were to move sharply in the wrong direction";[409] none of these purposes relate to compliance with the customer's instructions. The Bankruptcy Code amendments expressly refer not only to liquidation or close-out rights granted in the customer agreement, but also to rights set forth in DCO rules, and a "right, whether or not evidenced in writing, arising under common law, under law merchant or by reason of normal business practice."[410]

Similarly, the UCC acknowledges the right of a secured party, upon a default by the party granting a security interest, to exercise both the rights granted to the secured party by Part 6 of Article 9 of the UCC and, "except as otherwise provided in Section 9-602, those provided by agreement of the parties."[411] These rights are cumulative, and a secured party may exercise both the rights of foreclosure created by the security agreement and Article 9 itself, and any other contractual rights established by its

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406 RESTATEMENT (SECOND) OF AGENCY § 463 (1958).

407 *Hussain* v. *Saul Stone & Co.*, CFTC Docket No. 98-R153, 2003 WL 1908052, at *7 (2003) (quoting *Lee* v. *Lind-Waldock & Co.*, [1999-2000 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 28,173 at 50,159 (CFTC June 29, 2000)) ("[A]n FCM's duty to protect the financial position of its other customers and its right to protect its own financial position supersedes any duties it owes to the defaulting customer. In these circumstances, the Commission permits FCMs to make good faith judgments about the steps necessary to protect their financial interests. These steps may include liquidation of the defaulting customer's open positions.").

408 *Id.*

409 ~~*Id.*~~ *See* H.R. DOC. NO. 97-420, *infra* note 438, at *2; *see also Technical and Substantive Changes in Bankruptcy Law with Respect to Securities and Commodities: Hearing on H.R. 4935 Before the Subcomm. on Monopolies and Commercial Law of the H. Comm. on the Judiciary*, 97th Cong. 261 (1982) (statement of Rep. McClory) (explaining that the bill "is legislation designed to minimize the possibility that a bankruptcy in the securities or commodities industries will result in a chain reaction which could spread rapidly, injure many innocent parties, and ultimately even threaten disruption of the entire market structure"); *id.* at 164 (statement of Mr. Robert D. Boyle, Board of Trade Clearing Corp.) ("[I]f a major customer became insolvent or a major FCM became insolvent, there is, in my view, a material risk that the system could be destroyed. What we are trying to say is that there is this danger which must be cleaned up by really technical amendments.").

410 11 U.S.C. § 556 (2012).

411 ~~*Id.*~~ N.Y. UCC § 9-601(~~1~~a).

agreement with the debtor.[412] The customer agreements themselves, as well as DCO rules and long-standing custom and usage, create such additional rights.[413]

The provisions and history of the Bankruptcy Code are consistent with the understanding that an FCM, in closing out the positions that it carries for a defaulting customer, is exercising contractual rights that it is given by the customer under the customer agreement, the DCO rules, and industry practice, and not enforcing a security interest. The Bankruptcy Code protects the rights of a "commodity broker"[414] to exercise a "contractual right" to cause the liquidation, termination, or acceleration of a commodity contract (including a cleared swap ~~contract~~), and preserves the commodity broker's right to a variation or maintenance margin payment[415] received from a trustee with respect to open commodity contracts, notwithstanding any other provision of the Bankruptcy Code.[416] As noted above, a "contractual right" includes both a right granted by a contract, such as a clearing agreement with a customer, a DCO rule, under common law, under law merchant or under "normal business practice."[417] This safe harbor was intended to protect the "contractual rights" of "commodity brokers" (including FCMs) to close out customer positions.

Although the FCM does not act as the customer's agent in liquidating the customer transactions, the FCM will be required to account to the customer for any gains realized upon close out of positions and the customer will be liable to the FCM for any losses sustained and costs incurred. Furthermore, as in the exercise of any contractual right under New York law, it must act in accordance with its obligation of good faith and fair dealing.[418]

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412 *Id.* § 9-601(~~3~~c).

413 Although the UCC would permit the FCM to "enforce its security interest" after the customer's default, it also "makes clear that the rights provided in [Article 9] do not exclude other rights provided by agreement." ~~U.C.C.~~N.Y. UCC § 9-601 cmt. 2 (2012).

414 "Commodity brokers"~~"~~ include both "futures commission merchants" and "~~derivatives~~ clearing organizations." *See* 11 U.S.C. § 101(6) (2012).

415 "Initial margin" serves as "earnest money" to provide for future payments that a customer may be required to make, while "variation margin" is a settlement payment that extinguishes, rather than secures, exposures. *See Bankruptcy Act Revisions: Hearings on H.R. 31 and H.R. 32 before the Subcomm. on Civil & Constitutional Rights of the H. Comm. on the Judiciary*, 94th Cong., 2d Sess. 2382 (1976) ("Variation margin payments made by clearing members are exactly that, payments. They constitute losses. Once paid out by a clearing member to the clearing house, they are gone. They are not deposits, as are original margin deposits.").

416 11 U.S.C. § 556 (2012).

417 *Id.*

418 *See* 22A N.Y. Jur. 2d Contracts §~~-~~ 423 ("Every contract implies good faith and fair dealing between the parties to it."); *see*, *e.g.*, *Hartford Fire Ins. Co.* v. *Federated Dep't Stores, Inc.*, 723 F. Supp. 976, 991 (S.D.N.Y. 1989) ("Every contract governed by New York law ~~.~~ . . contains an implied covenant to perform the contract fairly and in good faith.").

2. Application of Customer Funds to Customer Obligations

(i) *Application to Payments to DCOs and Foreign Futures Brokers*

To the extent that the FCM is required to make payments to a DCO~~,~~ or to another member of ~~the related~~a trading facility, to margin, guarantee, secure, transfer, adjust, or settle the ~~customer transactions~~U.S. futures or cleared swaps of the customer, the statutory ~~trust~~trusts created by Section 4d~~(2)~~ of the CEA expressly ~~permits~~permit the FCM to "withdraw[] and appl[y]" the customer's customer funds to satisfy such obligations.[419] Thus, to the extent that the FCM is required to make payment to a DCO in connection with a customer's transactions, it is permitted by the CEA, and the terms that it establishes for each of the statutory ~~trust~~trusts under which the customer funds are held, to apply those funds directly to the obligations that the FCM has incurred in respect of the customer's transactions. The FCM debits the applicable account of the customer accordingly. If the FCM receives funds or other proceeds from any DCO, or other party, in respect of those transactions, the FCM credits the applicable account of the customer, and those additional funds or proceeds may be used to satisfy other obligations in respect of the transactions in the applicable account class.

Similarly, to the extent that the FCM is required to make payments to a foreign futures broker to margin, guarantee, secure, transfer, adjust, or settle foreign futures contracts carried for the customer, Rule 30.7(k) expressly permits the FCM to withdraw 30.7 customer funds from the 30.7 accounts to satisfy those obligations, as well as to pay commissions, brokerage, interest, taxes, storage, and other charges lawfully accruing in connection with the 30.7 customers' foreign futures contracts.[420]

The question arises whether the obligation to treat customer funds (including amounts accruing on any customer transaction) or foreign future customer funds as "belonging to" the customer,[421] or the treatment of the FCM as a "statutory trustee," would prevent an FCM from debiting the customer account or applying the segregated assets credited to the customer account to cover the obligations of the customer. Would the obligations of the FCM to the customer with respect to the segregated assets under the statutory trust impair the FCM's right to apply the funds and property in a customer account to the customer's obligation to indemnify and reimburse the FCM?

When a person holds funds or assets in trust for others, there is a question under New York law whether an unsecured obligation to a trustee who is holding property for a debtor is "mutual" with the trustee's obligation to the customer in respect

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419 7 U.S.C. § 6d (2010).

420 17 C.F.R. § 30.7(k).

421 *See* 7 U.S.C. § 6d (2012); 17 C.F.R. §§ 1.20 ~~and~~, 22.2, 30.7 (2020).

of that property, such that they may be set off against or applied to one another.[422] As the *Drexel* case noted, for example, "If a creditor's debt to his debtor arises from a fiduciary duty or in the nature of a trust, the creditor may not set off his claim against the debtor against his own liability because the parties are acting in different capacities and the debts of each side are not mutual."[423] There were two grounds for this conclusion — first, the court noted that, in general, "[t]o permit .~~..~~ . . setoff of a claim in the fiduciary's own right is at war with the fundamental principle that a fiduciary may never deal for his own profit with the subject matter of his trust."[424] Second, under the facts of the Drexel case in particular, mutuality did not exist because the banks did not have a debt to Drexel, but rather held the proceeds of collateral as bailee or constructive trustee for Drexel, "without color of lien."[425] Given this analysis, if an FCM holds the customer's property as a type of fiduciary, or as a statutory trustee, does that mean that the FCM cannot apply the customer's property in satisfaction of the customer's obligations to the FCM in its capacity as such?

A similar issue arose in the bankruptcy of Bevil, Bressler~~-~~ & Schulman Asset Management Corporation ("*Bevil Bressler*").[426] In that case, a counterparty to a repurchase agreement with Bevil Bressler had received coupon payments on securities that it had purchased from Bevil Bressler under three repurchase agreements. The repurchase agreements provided that Bevil Bressler would own any coupon payments made on the securities purchased by the counterparty, notwithstanding the fact that Bevil Bressler did not own the securities themselves.[427] The court permitted the counterparty to offset its obligation to resell the securities under the repurchase agreements to Bevil Bressler against the amounts due from Bevil Bressler to it, because "[i]t is clear that contractual obligations are debts for purposes of setoff."[428] However, because the counterparty "was merely a trustee .~~.~~ . . with respect to the coupon interest on the

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422 *See In re Drexel Burnham Lambert Grp. Inc.*, 113 B.R. 830, 843-44 (Bankr. S.D.N.Y. 1990); *see also In re Googel*, 130 B.R. 126, 129 (Bankr. D. Conn. 1991) ("It is well established that when an agent or bailee has possession of, but no interest in, a debtor's property, such property is not subject to setoff of any debt owing to the agent or bailee …. (Where bank in possession of debtor's property as bailee or constructive trustee, without color of lien, the bank does not owe a mutual debt to the debtor because title to the property does not lie in the bank but in the debtor.)").

423 *Drexel*, 113 B.R. at 847; *see also In re Weisberg*, 136 F.3d 655, 658 n.3 (9th Cir. 1998) ("In *Drexel*, the court noted the bank held the collateral as a bailee or constructive trustee, without color of lien. There could therefore be no mutual debt because the title to the property remained with the debtor.") (citations omitted).

424 *Drexel*, 113 B.R. at 848 (citing *Morris* v. *Windsor Trust Co*., 213 N.Y. 27, 32, 106 N.E. 753, 755 (1914)).

425 *Id.*

426 *Bevil, Bressler & Schulman Asset Management Corp.* v. *Savings Bldg. & Loan Co.*, 896 F.2d 54 (3d Cir. 1990).

427 *Id.* at 56.

428 *Id.* at 58.

bonds," the counterparty was simply holding Bevil Bressler's property and did not have a "debt" that it could set off against Bevil Bressler's obligations to it.

We do not believe that *Drexel*, *Bevil Bressler* and similar cases bar an FCM's use of the assets in a customer's ~~customer~~ account, including margin, to satisfy the customer's obligations in respect of the trading in that customer account.

First of all, any element of "trust" in the FCM-customer relationship derives either from the segregation requirement itself or from the mere fact that it holds title to the customer's property. Most importantly, to the extent that the CEA's segregation requirement itself gives rise to a statutory trust, that statutory trust is — by its own terms — subject to the FCM's right to use the segregated funds for this purpose. In fact, making sure that the funds are available for that purpose — and that purpose only — is the reason that the segregation requirement was imposed to begin with, and the CEA expressly recognizes this right of the FCM.[429] In addition, as discussed in Section VI.A above, the duties and rights of an agent, including an agent that holds property of its principal, can be varied by agreement, usage and practice, and by other laws, such as the CEA. Thus, any element of "trust" in the FCM's holding of the segregated funds is subject to the terms of the customer agreement (including custom and usage and applicable law), which expressly permits the FCM to utilize a customer's margin, and other assets in the customer account, to satisfy losses, costs, taxes, commissions, fees, and other amounts arising in relation to the FCM's trading on the customer's behalf — and subject to the provisions of the CEA.

As a result, the position of an FCM differs fundamentally from the situation described in the *Drexel* line of cases, in which the property in question was held in trust for a purpose completely unrelated to the purpose to which the fiduciary sought to apply it. For example, the *Drexel* court cited the "seminal trust case" of *Libby* v. *Hopkins*[430] as follows:

> The Supreme Court [in *Libby*] affirmed, reasoning that by remitting the payments to Stewart & Co., to be applied in accordance with his instructions, Hopkins did not intend to make the company his debtor, but his trustee. Stewart & Co. could not, by applying the funds entrusted to it for application to the mortgage loan *for an entirely different purpose*, create a debt upon which to base setoff, and thereby better his condition by refusing to execute the trust.

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429 *See generally supra* Section VI.A.

430 *Libby* v. *Hopkins*, 104 U.S. 303 (1881).

> There being no mutual debt contemplated by the parties, setoff was not permitted.[431]

In addition to the considerations described above, this reasoning does not apply to the FCM's application of the customer margin for several reasons.

As discussed above, from the outset, an FCM *does* have a lien or security interest (under both common law and, we have assumed, the customer agreement) in the customer account and any property credited to it, including the customer's beneficial interest in the customer transactions and their proceeds, and any margin provided by the customer. This is contemplated and agreed by the customer by virtue of having entered the customer agreement and having chosen to participate in a market where this was and remains accepted practice. In addition, under both common law and (we assume) the customer agreement, as well as under Section 4d of the CEA, the FCM has the right, when accounting to its customer, to deduct any advances made from the balance of the customer account.[432] In this respect, the situation differs entirely from the status of the coupons in question in the *Bevil Bressler* case as well, where the purpose of the "trust" in respect of the coupon payments was to ensure their return to the counterparty, not their availability to satisfy the counterparty's obligations.

Interpreting the fiduciary obligations of an FCM in respect of property held in a customer account to preclude the FCM from using that property to satisfy the customer's obligations in respect of the customer account would turn the commodities regulatory scheme on its head. A similar issue arose in *In re Pal-Playwell.*[433] In that case, the debtor had provided a security deposit to a landlord under a lease. Under the New York Real Property Law, the landlord was required to hold the security deposit in trust, as property of the lessee, unless and until the landlord applied the deposit to the lessee's

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431 *Drexel*, 113 B.R. at 848 (citing *Libby* v. *Hopkins*, 104 U.S. 303 (1881)) (emphasis added). In *Drexel*, Drexel was a guarantor of the obligations, the borrower under a loan agreement, and a participant in the same loan agreement. The other lenders under the loan agreement sought to set off the funds held by the agent for Drexel, as lender, against the obligations of Drexel as guarantor, notwithstanding that the agent was holding those funds for Drexel as a trustee — and not a trust holding funds deposited for the purpose of securing Drexel's obligations to the other lenders. There was also an element of sharp dealing that appears to have influenced the courts in both *Libby* and *Drexel* — the agent was seen as having in effect created a debt for the purpose of then using the proceeds of the debt as a setoff. The distinction between those cases and the practices being examined here is that, from the outset, all parties contemplated and agreed to the exercise of setoff rights to make the FCM whole where possible.

432 *Cf.* ~~U.C.C.~~N.Y. UCC § 8-509(c) (2012) ("The obligation of a securities intermediary to perform the duties imposed by Sections 8-504 through 8-508 is subject to: (1) rights of the securities intermediary arising out of a security interest under a security agreement with the entitlement holder or otherwise; and (2) rights of the securities intermediary under other law, regulation, rule, or agreement to withhold performance of its duties as a result of unfulfilled obligations of the entitlement holder to the securities intermediary.").

433 *In re Pal-Playwell, Inc*., 334 F.2d 389 (2d Cir. 1964). The *Drexel* court cited *Pal-Playwell* as an example of a case that should reach the opposite conclusion as compared with the conclusion reached in *Drexel*. *Drexel*, 113 B.R. at 849.

obligations. "To defeat the landlords' right to apply the deposit to satisfy the bankrupt's contractual obligations, the trustee argues that since section 233 made the landlords trustees of the deposit for the benefit of the bankrupt, there was no mutuality of debts and, therefore, there was no right to set-off under .~~.~~ . . the Bankruptcy Act."[434] The court disagreed, noting that:

> Although section 233 states that the deposit shall not become an asset of the person (the landlord) receiving it and shall not be mingled with his personal moneys, the section does not abrogate the landlord's right to apply the fund whenever necessary to insure fulfillment of the lessee's contractual obligations. Despite the depositor's continued ownership, it is an ownership burdened by the landlord's right to hold and use the money when required to secure performance.[435]

The court noted that the trust was a statutory trust, the purpose of which was to protect the lessee from the landlord using the funds deposited for any purpose other than the purpose authorized under the statute:

> That we are not dealing here with a trust in the conventional sense is made clear by the fact that the landlord may under the statute legitimately apply the deposit to damages he sustains due to the lessee's breach . . . . We do not believe that the trust established by section 233 is such as to require us to defeat the landlord's otherwise clear right to set-off the deposit under section 68a . . . . A holding to the contrary would contradict the plain intentions of the parties as well as undermine the purpose of the security arrangements and the applicable New York legislation.[436]

The same conclusion would apply to an argument that the fiduciary obligations that may be established by the regulations of the CFTC would preclude the FCM from utilizing the property for the very purpose for which it is provided. As Collier's confirms:

> Although funds held in trust are generally not eligible for setoff, an exception exists for security deposits that are specifically intended to afford the creditor some form of protection against the debtor's nonpayment. The rule is that

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434 *Pal-Playwell*, 334 F.2d at 390-91.

435 *Id.* at 391.

436 *Id.*

> if a particular deposit is intended to create a fund from which a setoff could be taken under applicable state law, but the fund is held in trust to protect the depositor's rights in the event no setoff is ever warranted, setoff should not be denied on the bare ground that the fund is held in trust.[437]

As discussed above, Section 4d of the CEA makes clear that the statutory trust and segregation of customer funds was intended for this purpose.

The legislative history surrounding the adoption of the safe harbors for commodity contracts in the U.S. Bankruptcy Code supports the conclusion that both the industry and the sponsors of the safe harbors recognized an FCM's ability to enforce its lien against the customer account and set off amounts following a customer default. These safe harbors were intended "to clarify that, despite the automatic stay of Section 362(a), . . . a commodity broker . . . may set off a claim for a margin or settlement payment arising out of commodities contracts, forward contracts, or securities contract[s] against cash, securities or other property which it is holding to margin, guarantee, or secure such contracts, notwithstanding the bankruptcy of the party for whose account such cash, securities, or property is held."[438] With respect to setoff of amounts in respect of customer transactions, the version of this safe harbor that was originally proposed referred only to mutual debts that "are" commodity contracts. Representatives from various agencies, including the Chairman of the CFTC, explained at the hearings that this language was problematic because a "court could incorrectly interpret this language narrowly to permit the setoff only where mutual debts and claims arise out of identical contracts that offset each other."[439] During the floor debate relating to the proposed safe harbors, Senator Dole explained:

> Section 3(c) of H.R. 4935 would amend section 362(b)(6) of the code to clarify that a commodity broker . . . may set off a claim for a margin or settlement payment against cash, securities, or other property which it is holding, notwithstanding the bankruptcy of the party for whose

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437 3 Collier Bankruptcy Manual ¶ 553.02. We note that an alternative argument for the FCM arises if the FCM is obligated to return any amounts held in trust for the customers as a debt to the customer because it commingles its own assets with those of all of its customers, as permitted under CFTC regulations. Therefore, the FCM's obligation to repay amounts held in trust for the customer and the customer's debt obligation to indemnify or otherwise make the FCM whole for amounts paid on contract cleared for that customer would be mutual.

438 TECHNICAL AND SUBSTANTIVE CHANGES IN BANKRUPTCY LAW WITH RESPECT TO SECURITIES AND COMMODITIES, H.R. DOC. NO. 97-420, at 3 (1982) ("This section does not permit a setoff which would be unlawful under any applicable law or regulation.").

439 *Technical and Substantive Changes in Bankruptcy Law with Respect to Securities and Commodities: Hearing on H.R. 4935 Before the Subcomm. on Monopolies and Commercial Law of the H. Comm. on the Judiciary*, 97th Cong. 166 (1982) (statement of Edmund R. Schroeder, New York Cocoa Clearing Association and the New York Coffee & Sugar Clearing Association); *id.* at 27 (statement of Mr. Philip F. Johnson, Chairman, Commodity Futures Trading Commission) ("This provision could be interpreted to refer only to the setoff of positions.").

> account such cash, securities or property is held and despite the automatic stay of section 362(a) .~~. .~~ . . . This means that if a commodity or securities brokerage firm, forward contract merchant, commodity clearing organization, or securities clearing agency has a claim for a margin or settlement payment against the debtor arising, before or after the filing of the petition, out of commodity contracts .~~ .~~ . . — or the liquidation of those contracts — and holds cash, securities or other property with respect to the same or other commodity contracts .~~. .~~ . . , it would not be stayed from setting off that claim against such cash, securities, or other property, or against any amount with respect to such contracts that it would be required to pay.
>
> Section~~-~~ 6 of H.R. 4935 also would add a new section 556 to the code to make explicit that the bankruptcy of an entity will not prevent a commodity broker or forward contract merchant from causing the liquidation of a commodity contract or forward contract because of a condition of the kind specified in subparagraphs (A), (B), or (C) of section 365(e)(1). The new section would also make explicit the right of a commodity broker or forward contract merchant to receive and retain variation or maintenance margin with respect to commodity contracts or forward contracts of a customer, when and as due, irrespective of whether the commodity contracts are specifically identifiable.[440]

These amendments did not create the rights in question, but recognized the liquidation and ~~set-off~~setoff rights, supported by an existing lien, that commodity brokers (*i.e.*, FCMs) already had over a customer's ~~customer~~ account to secure a commodity broker's right to reimbursement and exempted those rights from the automatic stay. Senator Dole affirmed in response to Senator Mathias's questions concerning offset between contracts cleared by the same commodity broker:

> Mr. Mathias: Accordingly, my question is whether a settlement payment owed to a customer with respect to a commodity contract, forward contract, or securities contract *is property held* by a commodity broker, forward contract merchant, or stockbroker *to guarantee or secure the customer's other contracts* within the meaning of section 3(c), and *may therefore be offset* against a margin or

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[440] 128 CONG. REC. 15,981 (1982).

settlement payment owed by the customer with respect to that or another contract.

Mr. Dole: Yes.[441]

Thus, even before Article 9 of the UCC was amended to make its provisions applicable to security interests in commodity contracts and commodity accounts, Congress believed that FCMs had the contractual right to offset the obligation to return margin against obligations owed to the FCM deriving from "a rule or bylaw of a derivatives clearing organization .~~..~~ . . , a multilateral clearing organization .~~..~~ . . , a national securities exchange, a national securities association, a securities clearing agency, a contract market designated under the Commodity Exchange Act, a derivatives transaction execution facility registered under the Commodity Exchange Act, or a board of trade .~~.~~ . . or in a resolution of the governing board thereof and a right, whether or not evidenced in writing, arising under common law, under law merchant or by reason of normal business practice."[442]

The operation of the specific statutory trust provided for under Section 4d (under which proceeds of closed-out customer transactions must be deposited in the segregated account and amounts payable to a DCO (or other applicable parties) in respect of closed-out customer transactions are debited from the segregated account), together with the related debits and credits to the customer account, results in a net balance payable to the customer, at the conclusion of the liquidation process, that reflects the net result of the close out of all ~~cleared customer~~ transactions cleared through all the DCOs through which those transactions were cleared, subject to the application of other costs, as discussed in Section XI.B.2(iii) below.

(ii) *Effect of Delivery of Margin in the Form of Securities*

Customers may deposit margin with an FCM in the form of cash or, subject to DCO rules and the agreement of the FCM, securities. We understand that it is the practice of FCMs, in general, to liquidate all of a customer's margin held in the form of securities upon the customer's default.[443] We have assumed that the customer

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441 *Id.* (emphasis added).

442 11 U.S.C. § 556 (2012) ("The contractual right of a commodity broker or forward contract merchant to cause the liquidation of a commodity contract, as defined in section 761(4) of this title, or forward contract because of a condition of the kind specified in section 365(e)(1) of this title, and the right to a variation or maintenance margin payment received from a trustee with respect to open commodity contracts or forward contracts, shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by the order of a court in any proceeding under this title. As used in this section, the term 'contractual right' includes a right set forth in a rule or bylaw of a clearing organization or contract market or in a resolution of the governing board thereof.").

443 Prior to the customer's default, the FCM holds the securities with the expectation that it will return them (or other assets equivalent in value) to the customer to the extent the customer supplies other

agreement grants to the FCM a security interest in any securities held in the customer's account~~. As noted in the Official Comments to Article 9 of the UCC:~~, and that these securities may form a significant portion of the margin posted by the customer.[444]

> ~~The main property that a commodity intermediary holds as collateral for the obligations that the commodity customer may incur under its commodity contracts is not other commodity contracts carried by the customer but the other property that the customer has posted as margin. Typically, this property will be securities. The commodity intermediary's security interest in such securities is governed by the rules of this Article on security interests in securities, not the rules on security interests in commodity contracts or commodity accounts.~~[445]

CFTC rules also affirmatively require an FCM to have a perfected security interest in securities held for a customer's account as a condition to the FCM's ability to offset those securities against any deficit in the customer's account when calculating the FCM's compliance with the segregation requirements.[446] Accordingly, the question has been raised whether the liquidation of such securities, and the application of proceeds, constitutes a foreclosure upon the customer's securities,[447] rather than an application of trust property to obligations for which the trust is maintained.

Neither Section~~-~~ 4d of the CEA nor the CFTC's regulations relating to the FCM's right to withdraw and apply the customer funds to the obligations arising in respect of customer transactions, nor the provisions of the CFTC's regulations determining the extent of the customer's interest in the segregated funds, differentiates between the FCM's right to withdraw and apply customer funds held in the form of securities as opposed to those held in the form of cash deposits.[448] Nonetheless, the CFTC

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margin as and when needed. Once the customer has defaulted, the FCM is no longer required to do so.

444 N.Y. UCC § 9-102 cmt. 6 (2012). *See supra* text accompanying note 281.

445 ~~U.C.C. § 9-102 cmt. 6 (2012).~~

446 17 C.F.R. § 1.32(b) (2020).

447 For this reason, as well as for purposes of compliance with the CFTC's regulations, it would be imprudent to forego complying with the requirements of the UCC with respect to the creation and perfection of the FCM's security interest in the customer funds. Moreover, an FCM may choose to exercise any rights that it may have under the UCC, to the extent it wishes to do so, as well as those that it has under the CEA. *Cf.* ~~U.C.C.~~N.Y. UCC § 9-601(~~3~~c) (2012).

448 Before the amendments to the Bankruptcy Code, customers of a failed FCM may have been able to claim the specific securities that they provided to an FCM as "specifically identifiable property" of that customer that could be reclaimed from the FCM's insolvency estate. As a result, the CFTC had required that margin in the form of securities be held separately from other margin, and that any deficits in the account of the customer who deposited securities as margin must be covered by a deposit in segregation of an equivalent amount of the FCM's own money. Treatment of Government Securities Deposited as Customer Funds, Comm. Fut. L. Rep. ¶ 21,101. However,

has required that an FCM, as a condition to accepting securities as margin, must have a security interest in the securities and must receive the customer's "written authorization to liquidate the customer's [securities] at [the FCM's] discretion in order to protect the firm and to cover any deficit in the customer's account."[449] However, much as the security interest over the customer transactions in a customer account protects the FCM against intervening claims by third parties, the security interest in the customer's margin delivered in the form of securities protects the FCM from efforts by third parties, or the customer, to prevent the FCM from liquidating the securities margin when the FCM deems it necessary to do so. Furthermore, CFTC rules prohibit an FCM from making loans on an unsecured basis to finance customers' trading and prohibits an FCM from loaning funds to customers secured by the customer accounts of such customers.[450] Accepting securities as margin without a security interest in the securities would presumably violate such rule.

FCMs may liquidate securities held as margin in the event of a customer default. In such a case, securities may be liquidated as margin rather than an exercise of the FCM's security interest.[451]

(iii) *Application to Other Obligations of the Customer*

~~Other~~Chargeable costs, consisting of charges incurred by the FCM in the course of acting for its customer, such as commissions payable to introducing brokers, that are not "necessary" to the execution or maintenance of customer transactions may not be deducted from the customer funds held in the segregated account.[452] However, they may be charged to the customer account to the extent provided in the customer

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because the 1978 amendments to the Bankruptcy Code precluded such actions by customers, the CFTC eliminated that requirement because the Bankruptcy Code now prevented customers from interfering with the distribution of the segregated funds in the FCM's bankruptcy.

449 Treatment of Government Securities Deposited as Customer Funds, Comm. Fut. L. Rep. ¶ 21,101. An FCM that holds securities as margin would be required to take a capital charge if it does not have a security interest in the margin. *See, e.g.*, Financial and Segregation Interpretation No. 10, CFTC Division of Trading and Markets, *available at* https://www.cftc.gov/sites/default/files/tm/tmint-10.htm.

450 17 C.F.R. §- 1.30 (2020).

451 For a detailed analysis of how FCMs liquidate securities held as margin in the event of a customer default, please see our Memorandum to International Swaps and Derivatives Association, Inc. & Futures Industry Association, dated November 21, 2018, re: Analysis of the Relationships Among Customers, FCMs and DCOs Under the U.S. Agency Clearing Model (on file with author).

452 "Commissions earned by APs and IBs are not necessary to the execution of commodity trades and maintenance of any resulting positions. Consequently, commissions due an IB or AP constitute a general obligation of the FCM and, as such, may not be paid by the FCM directly out of funds segregated for the benefit of commodity customers, even though commissions may have been charged to customers' accounts and the funds themselves not yet transferred from a segregated depository to an operating account of the FCM, and even though the customer need not itself pay such commissions by means of a separate transfer to the FCM." *See* Financial and Segregation Interpretation No. 14, *supra* note ~~87.~~ 119.

agreement.[453] By charging the customer account for these chargeable costs, and reducing the FCM's liability to the customer in respect of the customer account balance accordingly, the customer's interest in the funds held in segregation is also reduced by the relevant amount.[454]

This reduction in the customer's interest in the segregated account is evident in the interaction between CFTC Rules 1.20 and 1.23. Under Rule 1.20, an FCM may not commingle segregated customer assets with its own property,[455] except to the extent permitted by CFTC Rule 1.23. CFTC Rule 1.23 permits (and in some cases requires) an FCM to (1) have a residual interest in the customer funds segregated under CFTC Rule 1.20,[456] and (2) deposit its own property in the segregated account to the extent the FCM deems necessary to prevent "any and all futures customers' accounts from becoming undersegregated at any time."[457] While Rule 1.23 initially was aimed at ensuring that the inclusion of FCM assets in the segregated account did not impair the rights of customers in the account,[458] Rule 1.23 has developed over time to its current incarnation, which affirmatively requires that an FCM maintain a "targeted residual interest (*i.e.*, excess funds)" in segregation at all times.[459] As CFTC Rule 1.23 now stands, it makes clear that the customers' collective interest, and the interest of any given customer, in the funds held in segregation rises and falls with the net liquidating equity of the customer account. An FCM is permitted (subject to completing its daily segregation calculation) to "make withdrawals [from the segregated account] .~~—~~ . . to the extent of its actual residual financial interest in funds held in segregated futures accounts."[460]

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453 *Cf. id.* (In the FCM's bankruptcy, "commissions owed the FCM or payable by the FCM to third parties that are chargeable to a customer's account pursuant to a contractual arrangement, but not yet charged to such customer's account, must, based upon the FCM's right of offset, be subtracted from the net equity claim (the liability owed to that customer by the FCM in bankruptcy) of the individual customer whose account incurred the charges.").

454 *Id.* ("This limitation on recovery does not result in a windfall to the customer who does owe the commissions, however, *because the FCM's liability to that customer*, and hence the money payable to that customer in bankruptcy, *must be reduced by the amount of commissions earned, but not yet charged to that customer's account, thereby reducing such customer's claim against assets segregated for customers generally*~~.").~~.")

455 17 U.S.C. § 6d; 17 C.F.R. §- 1.20 (2020).

456 "An FCM's residual interest consists only of funds deposited in the segregated account to the extent they are not needed to satisfy the FCM's segregation requirements." Financial and Segregation Interpretation No. 14, *supra* note ~~87.~~119.

457 17 C.F.R. §- 1.23(a) (2020).

458 *See id.* §- 1.23, which simply permitted the inclusion of FCM proprietary assets while requiring clear accounting to distinguish the FCM's interest from that of its customers and cautioned against withdrawals of proprietary assets resulting in a deficit in the segregated account.

459 *Id.* § 1.23(c).

460 *Id.* §- 1.23(b). Notwithstanding the fact that the funds in the account exceed the amount that the FCM is required to maintain in segregation, the assets in the segregated account remain subject to the requirements of Rule 1.20 until they are withdrawn; however, to the extent the funds are excess funds — *i.e.*, represent the residual financial interest of the FCM — they may be withdrawn from the segregated account to the extent permitted by Rule 1.23.

Moreover, this "residual financial interest" is available to satisfy claims of the FCM's creditors in the event of the FCM's failure.[461] In other words, because the customer's claim against the FCM is reduced by the debit to the customer account, the customer's interest in the segregated funds is reduced as well.

XII. TREATMENT OF CLOSE OUT IN CUSTOMER INSOLVENCY

Although the contractual and regulatory framework for the liquidation of a customer's positions upon the customer's default – including an insolvency default – is clear, the provisions of applicable insolvency regimes impose restrictions that may limit the ability of an FCM to complete the liquidation process or the ability of an uncleared swaps affiliate to exercise its cross-affiliate netting rights. In general, insolvency regimes grant broad powers to the court or person charged with resolving the rights and obligations of the insolvent entity and the parties with which it has dealt. These powers can invalidate many otherwise valid contractual provisions and force the insolvent entity's counterparties and agents to forego rights that they bargained for or make payments they otherwise would not be obligated to make. However, as discussed below, each of the primary statutes governing the bankruptcy or resolution procedures applicable to major participants in the futures and swaps markets have been amended to permit FCMs and uncleared swaps affiliates to exercise the rights described in Section- IX above.

In the United States, different insolvency statutes apply to different types of entities and, in some cases, the same entity may be subject to both a primary insolvency regime and the "special resolution regime" established by Title II of Dodd-Frank. Accordingly, this Section- XII reviews each of the principal insolvency statutes applicable to the types of customers referred to in Section- II above. If the customer is a "covered entity" within the meaning of 12 C.F.R. § 252.82(b), a "covered FSI" within the meaning of 12 C.F.R. § 382.2(b), or a "covered bank" within the meaning of 12 C.F.R. §- 47.2(b), it will be subject to the QFC resolution stay regulations ("*QFC Stay rules*") and, notwithstanding other remedies that may be available under the insolvency regimes set forth below, the parties will have agreed not to exercise these conditions until the stay protocol is satisfied, pursuant to the requirements of the QFC stay rules.

A. Customers Subject to the Bankruptcy Code (Full Proceeding, ~~customers other than~~Customers Other Than Broker-Dealers and FCMs)

The Bankruptcy Code[462] is the principal insolvency statute in the United States, in the sense that it applies to most individuals, legal entities, and municipalities. It

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461 Financial and Segregation Interpretation No. 14, *supra* note ~~87~~119 ("An FCM's residual interest consists only of funds deposited in the segregated account to the extent they are not needed to satisfy the FCM's segregation requirements. Third-party creditors have no interest in an FCM's segregated funds in bankruptcy, although when all customer liabilities are paid, any excess segregated funds revert to the FCM debtor's general estate.").

462 Title 11 of the U.S. Code.

does not, however, apply to all legal entities, including many who are involved in trading in the futures markets. The Bankruptcy Code substantially limits the right of a creditor, such as an FCM, to take actions that affect the rights or property of a debtor that is subject to a proceeding under the Bankruptcy Code, but has been amended specifically to permit FCMs to exercise their contractual rights to liquidate a customer's positions in the event of the customer's default.

The Bankruptcy Code provides for both "full" bankruptcy proceedings, where the proceeding under the Bankruptcy Code seeks to address all the property of the debtor and resolve all the obligations of the debtor globally, and proceedings under Chapter 15 of the Bankruptcy Code, in which the proceeding under the Bankruptcy Code is generally limited to assets within the territorial jurisdiction of the United States and the proceeding is generally conducted in coordination with a primary proceeding in another jurisdiction.[463] Moreover, with respect to "full" bankruptcy proceedings, the Bankruptcy Code provides for two types of bankruptcy cases for entities that are subject to its provisions: (i) a liquidation of the debtor's assets and distribution of the proceeds in accordance with the rule of strict priority by a trustee, pursuant to Chapter 7 of the Bankruptcy Code; and (ii) a reorganization of the debtor in which property or new securities of the debtor are distributed to creditors pursuant to a plan of reorganization, under Chapter 11 of the Bankruptcy Code. In most corporate reorganization proceedings under Chapter 11, the existing management of the debtor continues to operate the corporation as "debtor-in-possession,"[464] while in a liquidation under Chapter 7, the liquidation is conducted by a trustee in bankruptcy. There are significant procedural differences between a Chapter 7 liquidation and a Chapter 11 reorganization and, of course, the ultimate goal of the two proceedings is different. However, except as indicated in this memorandum, our conclusions with respect to the matters discussed in this Section XII.A would not differ under the two types of proceedings.[465]

1. Entities Covered by the Bankruptcy Code

Any individual, partnership, or corporation[466] that resides or has a domicile, place of business, or property in the United States may be a debtor under the Bankruptcy Code.[467] However, the Bankruptcy Code does not apply to most types of U.S.

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463 As discussed in more detail in Section XII.G below, this memorandum does not address the effect that ancillary proceedings under the laws governing insurer insolvency of a state may have on an FCM's rights with respect to customer transactions.

464 A trustee is appointed in place of the debtor-in-possession most often when there is evidence of fraud or mismanagement by the debtor's management, or when such an appointment is otherwise in the best interests of creditors. If the debtor is permitted to remain in possession of the bankruptcy estate in a reorganization proceeding, the debtor-in-possession has all the rights and powers of a trustee. 11 U.S.C. § 1107(a). Thus, the descriptions in this letter of a trustee's rights and powers would apply equally to a debtor-in-possession in a reorganization proceeding.

465 *See* 11 U.S.C. § 561(d).

466 *Id.* § 101(41).

467 *Id*. § 109(a).

banks and insurance companies,[468] to non-U.S. insurance companies engaged in the insurance business in the U.S.,[469] to foreign banks that maintain branches or agencies in the U.S.,[470] to small business investment companies,[471] or to trusts that are not engaged in business (including most employee benefit plans).[472]

A customer of an FCM that is itself a commodity broker, may be subject to the provisions governing the liquidation of commodity brokers contained in Subchapter IV of Chapter 7 of the Bankruptcy Code, in addition to the related Part 190 regulations of the CFTC.[473] However, if the customer is a broker-dealer, whether or not the customer is also an FCM, the proceeding in respect of the broker-dealer would likely be conducted under SIPA. Broker-dealers are addressed in Section XII.B below, and customers who are commodities brokers are addressed in Section XII.B below.

Accordingly, this section addresses only individuals, partnerships, and corporations that reside or have a domicile, place of business, or property in the United States and that are not U.S. banks or insurance companies, non-U.S. insurance companies engaged in the insurance business in the U.S., foreign banks that maintain branches or agencies in the U.S., small business investment companies or trusts that are not engaged in business (including most employee benefit plans).

2. Restrictions and Powers of the Trustee

Absent the safe harbor provisions discussed below, the commencement of a proceeding against a customer under the Bankruptcy Code would give the trustee in bankruptcy conducting the proceeding the power to invalidate or reverse certain transactions that occurred between the FCM and the defaulting customer prior to the commencement of the proceeding, and limit the FCM's ability to exercise its contractual rights against the defaulting customer under its customer agreement and the CEA.

(i) *Avoidance of Pre-Petition Transfers*

The most significant powers of the trustee to invalidate or reverse pre-proceeding transactions are the powers of the trustee to avoid transfers that constitute

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468 *Id.* § 109(b)(2). The Bankruptcy Code authorizes certain types of U.S. specialized banking entities — uninsured State member banks or "Edge Act" corporations that operate multilateral clearing organizations pursuant to section 409 of FDICIA – to be debtors in a liquidation proceeding under Chapter 7 of the Bankruptcy Code if a petition is filed at the direction of the Board of Governors of the Federal Reserve System, and to be debtors in a reorganization proceeding under Chapter 11 of the Bankruptcy Code. However, section 409 of FDICIA has been repealed, leaving the status of this provision unclear.

469 *Id.* § 109(b)(3)(A).

470 *Id.* § 109(b)(3)(B).

471 *Id.* § 109(b)(2).

472 *Id*. §§ 101(9), (41).

473 17 C.F.R. § 190 (2020).

"preferences"[474] and transfers that constitute "fraudulent transfers."[475] Under Section 547 of the Bankruptcy Code, a trustee in bankruptcy may avoid as a "preference" (*i.e.,* reverse) any transfer of an interest of a debtor in property (i) to or for the benefit of a creditor, (ii) for or on account of an antecedent debt owed by the debtor before such transfer was made, (iii) made while the debtor was insolvent, (iv) made within 90 days before the filing of a petition under the Bankruptcy Code (or one year if the creditor was an "insider" of the debtor) and (v) that enables the creditor to receive more than it would receive if the bankruptcy case were a case under Chapter 7 of the Bankruptcy Code (*i.e.*, a liquidation and distribution pursuant to the rule of strict priority), the transfer had not been made, and the creditor received payment of such debt to the extent provided by the Bankruptcy Code.[476]

In addition, under Section 548(a) of the Bankruptcy Code, a trustee in bankruptcy may avoid any transfer of a debtor's property or debt incurred by a debtor within two years before a petition is filed under the Bankruptcy Code if (i) the debtor made the transfer or incurred the obligation with "actual intent to hinder, delay or defraud" present or future creditors, or (ii) the debtor received less than "a reasonably equivalent value" in exchange for the transfer or obligation and the debtor (a) was insolvent on the date the transfer was made or debt was incurred or became insolvent as a result of the transfer or debt, (b) was engaged in business or in a transaction, or was about to do so, for which any property remaining with the debtor was an unreasonably small capital, (c) intended to incur or believed that it would incur debts beyond its ability to pay as they matured, or (d) made the transfer to or for the benefit of an insider, or incurred the obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.[477] "Value" means "property, or satisfaction or securing of a present or antecedent debt of the debtor."[478]

In addition, under Section 544(b) of the Bankruptcy Code, a trustee in bankruptcy may avoid a transfer made prior to the filing of a bankruptcy petition if the transfer is voidable by an unsecured creditor under applicable state law[479]— sometimes referred to as the trustee's "strong-arm" powers. New York's fraudulent ~~transfer~~conveyances law[480] permits a creditor to recover property conveyed by a debtor to third parties under circumstances generally similar to those described above. ~~However,~~

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474 11 U.S.C. § 547(b).

475 *Id.* § 548(a)(1). In addition, under Section 544(b) of the Bankruptcy Code, a trustee in bankruptcy may avoid a transfer made prior to the filing of a bankruptcy petition if the transfer is voidable by an unsecured creditor under applicable state law. *Id.* § 544(b).

476 *Id.* § 547(b).

477 *Id.* § 548(a)(1).

478 *Id.* § 548(d)(2)(A).

479 *Id.* § 544(b). Transfers that may be avoided by a trustee under ~~Sections~~ Section 548(a) or Section 544(b) of the Bankruptcy Code may be recovered both from the initial transferee and from a subsequent transferee, subject to the limitations specified in the Bankruptcy Code.

480 N.Y. DEBT. & CRED. ~~LAW §~~L. Art. 10 (McKinney 2020).

~~(i) a transfer or obligation for which the debtor does not receive "fair consideration" may also be avoided under the New York statute if the debtor is a defendant in an action that results or has resulted in an unsatisfied judgment against the debtor[481] and (ii) in general, fraudulent transfers~~[482] However, in general, fraudulent conveyances made or obligations incurred within six years prior to the commencement of the bankruptcy case or insolvency proceeding may be avoided.[483]

In the absence of the safe harbors discussed below, these provisions might permit a trustee in bankruptcy, or a debtor-in-possession, to reverse pre-petition transfers of margin or other amounts by the customer to the FCM.

(ii) *Restrictions on Actions After the Commencement of the Proceeding*

In addition, various provisions of the Bankruptcy Code would generally prohibit the exercise of remedies against the debtor following the commencement of a proceeding. First, under Section 362 of the Bankruptcy Code, the filing of a petition under the Bankruptcy Code operates as a stay of, among other things, any act to collect a pre-petition claim against the debtor, any act to create, perfect or enforce any lien against property of the debtor, or the setoff of any pre-petition debt owing to the debtor against any claim that a party may hold against the debtor.[484] As a general matter, unless a specific exemption is set forth in the Bankruptcy Code, the stay applies to all parties unless and until either the bankruptcy case is completed or the court grants relief from the stay with respect to a particular party.[485] The trustee may avoid any action taken in violation of the automatic stay.[486] Furthermore, if an action in violation of the stay is willful, the person taking the action may be subject to sanction.[487]

~~[481] *Id.* § 273-a. New York recently passed a new fraudulent transfer law that repeals and replaces the old Article 10, and which, among other changes, uses a "reasonably equivalent value" standard in place of the existing fair consideration standard. 2019 N.Y. Sess. Laws 5622 § 273(a)(2) (McKinney 2020) ("A transfer made or obligation incurred by a debtor is voidable as to a creditor . . . if the debtor made the transfer or incurred the obligation: . . . without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor: (i) was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or (ii) intended to incur, or believed or reasonably should have believed that the debtor would incur, debts beyond the debtor's ability to pay as they became due.").~~

[482] In 2020, New York passed a new fraudulent conveyance law that repealed and replaced the prior Article 10, and which, among other changes, instituted a "reasonably equivalent value" standard in place of the previous "fair consideration" standard. 2019 N.Y. Sess. Laws 5622 § 273(a)(2) (McKinney 2020).

[483] N.Y. CIV. PRAC. L. & R. § 213(8) (McKinney 2020).

[484] 11 U.S.C. § 362(a). As noted above, a stay may arise in an ancillary proceeding as well.

[485] *Id.* § 362(c).

[486] *Id.* § 549(a)(2)(B).

[487] *Id.* § 362(k).

The commencement of a bankruptcy proceeding also limits or precludes the exercise of rights of setoff in several ways. As noted in the prior paragraph, the automatic stay in bankruptcy cases prohibits the exercise of a right of setoff until the stay is lifted or the case is concluded. Until then, the creditor with a right of setoff is treated as a secured creditor with a lien on its indebtedness to the debtor in bankruptcy.[488]

Second, the Bankruptcy Code prohibits the exercise of any setoff against a debtor if the setoff involves a claim against the debtor that was transferred to the creditor after the commencement of the case, or within 90 days before the commencement of the case while the debtor was insolvent; or a debt owed by the creditor to the debtor that was incurred within 90 days before the commencement of the case, while the debtor was insolvent, for the purpose of obtaining a right of setoff.[489]

Third, the trustee may also avoid any setoff made within 90 days before the commencement of the bankruptcy case to the extent that it would "improve the position" of the creditor over the position they would have been in if it had set off on the 90th day before the filing of the petition (or the first day during that 90-day period on which the claim of the creditor against the debtor exceeded the debt of the creditor to the debtor).[490] In addition, a creditor may not offset a claim that arose after the commencement of the case against a claim that arose before the commencement of the case.[491]

Furthermore, the Bankruptcy Code invalidates any clause that purports to modify or terminate, after the commencement of a bankruptcy proceeding, the debtor's rights under an executory contract based on the insolvency of the debtor, its financial condition, or the commencement of a bankruptcy proceeding in respect of the debtor (an "*ipso facto*"" clause).[492] Accordingly, even if a contract gives a party the right to terminate the contract upon the other party's bankruptcy, that right cannot be exercised.

As is the case with respect to the trustee's avoidance powers, these post-petition limitations would significantly limit an FCM's rights following its customer's default, but for the adoption of the safe harbors described below.

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488 *Id.* § 506(a)(1).

489 The debtor is presumed to have been insolvent for the 90 days preceding the commencement of the case. *Id.* § 553(c). Section 553(a)(1) also prohibits the exercise of a setoff of a debt owing to the debtor against a claim that is disallowed. *Id.* § 553(a)(1).

490 *Id.* § 553(b).

491 *Id.* § 553(a).

492 *Id.* § 365(e)(1). There is an exception to this rule for "financial accommodation" contracts, such as an obligation to extend new loans. *Id.* § 365(e)(2)(B).

(iii) *Ability of the Trustee to Reject or Transfer Contracts*

The trustee in bankruptcy generally may assume or reject a debtor's "executory contracts."[493] Although the term is not defined in the Bankruptcy Code, an "executory contract" generally includes any contract under which "the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other."[494] Other contracts have been found to be "executory" contracts, however, particularly when the debtor continues to owe significant performance under the contract.

If the trustee assumes a contract, it must assume the contract as a whole, and must comply with all the debtor's obligations under the contract and cure (or provide "adequate assurance" that it will promptly cure) any outstanding defaults other than "*ipso facto*" defaults and other types of defaults that could not be enforced against the bankruptcy estate.[495] Having assumed the contract, the trustee may then assign the contract to a third party, regardless of any restrictions on transfer contained in the contract or under applicable law, subject to limited exceptions for "personal services" contracts, financing agreements, and some types of real property leases.[496] The trustee may assign the contract notwithstanding any provision of the applicable contract, or any provision of applicable law, to the contrary.[497]

If the trustee rejects a contract, the counterparty is no longer entitled to performance by the debtor under the contract. Instead, the counterparty has a claim for damages calculated as if the debtor had breached the contract immediately before the bankruptcy case was commenced or, if it is rejected after first being assumed, at the time of the rejection.[498]

3. Safe Harbors as Applied to Liquidation of ~~Cleared Customer~~ Transactions and Foreign Futures ~~Contracts~~

In 1982, the Bankruptcy Code was amended to include expansive safe harbors for both pre- and post-petition actions by an FCM in connection with the liquidation of ~~cleared customer~~ transactions carried for a customer that had entered bankruptcy proceedings.[499] These safe harbors were substantially amended and expanded in 1982, and have been amended several times since then, including particularly by the

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493 *Id.* § 365(a).

494 *See, e.g.*, Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973).

495 11 U.S.C. § 365(b).

496 *Id.* § 365(c).

497 *Id.* § 365(f)(1).

498 *Id.* § 365(g).

499 When the Bankruptcy Code was initially enacted in 1978, it contained some protections for parties to commodities and forward contracts. *See* 5 Collier on Bankruptcy ¶ 556.LH.

Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (*"BAPCA"*). [500] These safe harbors were intended to "prevent the insolvency of one commodity or security firm from spreading to other firms and possibly threatening the collapse of the affected market."[501]

Specifically, Section 556 of the Bankruptcy Code provides that the exercise by an FCM of a "contractual right" to cause the liquidation, termination or acceleration of a "commodity contract" or "forward contract" as a result of the customer's bankruptcy or financial condition, and the right of the FCM to a variation or maintenance margin payment received from the trustee of a customer in bankruptcy, will not be stayed, avoided or otherwise limited by any provision of the Bankruptcy Code or by the order of any court in a proceeding under the Bankruptcy Code.[502] For this purpose, a "contractual right" includes not only a right set forth in an agreement between the customer and the FCM, such as a customer agreement, but also any right set forth in a rule or bylaw of a DCO, a national securities exchange, a national securities association, a securities clearing agency, a contract market designated under the CEA, a derivatives transaction execution facility registered under the CEA, or a board of trade as defined in the CEA, as well as a right, whether or not evidenced in writing, arising under common law, under law merchant or by reason of normal business practice.[503] Furthermore, Section 362(b)(6) of the Bankruptcy Code permits an FCM to exercise any such contractual right under any security agreement or arrangement, or other credit enhancement, forming a part of or related to any "commodity contract" or "forward contract" or any contractual right to offset or net out any termination value, payment amount or other transfer obligations arising under or in connection with one or more "commodity contracts" or "forward contracts," notwithstanding the automatic stay.

These provisions apply to "commodities contracts" and "futures contracts" as defined in the Bankruptcy Code. The Bankruptcy Code defines "commodity contracts" to include, in relevant part:

> (a) with respect to a futures commission merchant, a contract for the purchase or sale of a commodity for future delivery on, or subject to the rules of, a contract market or board of trade;
>
> (b) with respect to a foreign futures commission merchant (*i.e.*, an entity that accepts orders for the purchase or sale of foreign futures or accepts customer property or extends credit to margin, guarantee or secure any foreign

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500 *Id.*

501 TECHNICAL AND SUBSTANTIVE CHANGES IN BANKRUPTCY LAW WITH RESPECT TO SECURITIES AND COMMODITIES, H.R. DOC. NO. 97-420, at 1 (1982).

502 11 U.S.C. § 556.

503 *Id.*

future),[504] any contract for the purchase or sale of a commodity for future delivery on, or subject to the rules of, a board of trade outside the United States;[505]

(c) with respect to a commodity options dealer, an agreement ("*commodity option*") subject to regulation under Section 4c(b) of the CEA;

(d) any other contract, option, agreement, or transaction that is similar to any contract, option, agreement, or transaction referred to in the definition of "commodity contract" and any other contract, option, agreement, or transaction that is cleared by a clearing organization;

(e) any combination of the agreements or transactions referred to in the definition of "commodity contract";

(f) any option to enter into an agreement or transaction referred to in in the definition of "commodity contract";

(g) a master agreement that provides for any such agreement or transaction, together with all supplements to such master agreement;[506] or

(h) any security agreement or arrangement or other credit enhancement related to any such agreement or transaction, including any guarantee or reimbursement obligation by or to an FCM in connection with any such agreement or transaction.[507]

Cleared ~~swap contracts~~swaps are treated as "commodity contracts" for purposes of the Bankruptcy Code.[508]

The term "forward contract," for purposes of the Bankruptcy Code, includes:

(a) a contract (other than a commodity contract, as defined above) for the purchase, sale, or transfer of a commodity ~~.~~ . with a maturity date more than two days after the date the contract is entered into, including, but not limited to, a repurchase or reverse repurchase transaction ~~.~~ . consignment, lease, swap,

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504 *Id.* § 761(12).

505 *Id.* § 761(11).

506 If the master agreement provides for both contracts that would be treated as "commodity contracts" and for other types of transactions, then the agreement is considered to be a "commodity contract" only with respect to each agreement or transaction under the master agreement that otherwise falls within the definition of "commodity contract." *Id.* § 761(4)(I).

507 *Id.* 761(4)(j).

508 *Id.* § 761(1)(F)(i); Dodd-Frank Act § 724(b).

hedge transaction, deposit, loan, option, allocated transaction, unallocated transaction, or any other similar agreement;

(b) any combination of agreements or transactions referred to in paragraphs (a) above or and paragraph (c) below;

(c) any option to enter into an agreement or transaction referred to in paragraph (a) or (b) above;

(d) a master agreement that provides for an agreement or transaction referred to in one of the prior paragraphs, together with all supplements to such agreement;[509] or

(e) any security agreement or arrangement or other credit enhancement related to any such agreement or transaction, including any guarantee or reimbursement obligation by or to an FCM in connection with any such agreement or transaction.[510]

Accordingly, these definitions encompass all the types of contracts that constitute "~~cleared customer~~ transactions" for purposes of this memorandum, and the FCM may exercise its rights under the customer agreement, the CEA and related CFTC regulations, and applicable DCO or foreign clearing organization rules, to cause the liquidation, termination or acceleration of these contracts, to retain any margin or settlement payments received under these contracts, to exercise any contractual right under any security agreement or arrangement, or other credit enhancement, forming a part of or related to any such contracts, and to offset or net out any termination value, payment amount or other transfer obligations arising under or in connection with one or more of such transactions, notwithstanding the restrictions that otherwise would apply under the Bankruptcy Code.[511] However, if the customer itself is a commodity broker, these rights may be limited, as discussed below.

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509 Again, if the master agreement provides for both contracts that would be treated as "forward contracts" and for other types of transactions, then the agreement is considered to be a "forward contract" only with respect to each agreement or transaction under the master agreement that otherwise falls within the definition of "forward contract." 11 U.S.C. § 101(25)(D).

510 *Id.* § 101(25).

511 The current case law confirms that safe harbors generally do not apply to commissions and other charges, except in the case where brokers' commissions and fees may be protected as settlement payments under Section 546(e). *See, e.g.*, *In re Derivium Capital LLC*, 716 F.3d 355 (4th Cir. 2013) (finding that 11. U.S.C.S. §- 546(e) does not exclude from the definition of "~~"~~settlement ~~payment"~~payment" payments from which brokers benefit, such as commissions and fees). This accords with the legislative history, as the floor remarks of Senators Mathias and Bob Dole before the Senate's vote on the legislation clarify:

> Mr. Mathias: I understand that the purpose of the narrower language of section 3(c) is to prevent setoffs for charges such as commissions, or by entities such as banks, which are not necessary to achieve the market protection functions of section 362(b)(6).~~. . .~~ . . . my

If an FCM has established portfolio margining arrangements as described in Section VIII, some of the customer transactions may not constitute "commodity contracts" or "forward contracts" within the definitions set forth above. Those contracts may instead constitute "securities contracts," as defined in Section 741 of the Bankruptcy Code. This term includes, in relevant part:

> (a) a contract for the purchase, sale, or loan of a security, a certificate of deposit, a mortgage loan, any interest in a mortgage loan, a group or index of securities, certificates of deposit, or mortgage loans or interests therein (including an interest therein or based on the value thereof), or option on any of the foregoing instruments, including an option to purchase or sell any such instrument, and including any repurchase or reverse repurchase transaction on any such instrument;
>
> (b) the guarantee (including by novation) by or to any securities clearing agency of a settlement of cash, securities, certificates of deposit, mortgage loans or interests therein, group or index of securities, or mortgage loans or interests therein (including any interest therein or based on the value thereof), or option on any of the foregoing instruments, including an option to purchase or sell any such instrument (whether or not such settlement is in connection with any agreement or transaction that would otherwise be a securities contract);
>
> (c) any other agreement or transaction that is similar to an agreement or transaction referred to in this definition;
>
> (d) any combination of the agreements or transactions referred to in this definition;
>
> (e) any option to enter into any agreement or transaction referred to in this definition;

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question is whether a settlement payment owed to a customer . . . is property held by a commodity broker . . . within the meaning of section 3(c), and may therefore be offset against a margin or settlement payment owed by the customer with respect to that or another contract.

Mr. Dole. Yes.

128 CONG. REC. S15,981 (daily ed. July 13, 1982) (statements of Sens. Dole and Mathias). Thus, commissions paid as "part of settling a regular securities transaction," as opposed to those that are "not part of the settlement of securities transaction" or which are "not actually related to closing trades," are within the plain language and legislative intent of Section 546(e)'s protection. *In re Derivium Capital LLC*, 716 F.3d at 364-65.

(f) a master agreement that provides for an agreement or transaction referred to in this definition, together with all supplements to any such master agreement;[512] or

(g) any security agreement or arrangement or other credit enhancement related to any agreement or transaction referred to in this definition, including any guarantee or reimbursement obligation by or to a stockbroker, securities clearing agency, financial institution, or financial participant in connection with any such agreement or transaction.[513]

The Bankruptcy Code includes safe harbors that protect the rights of certain parties to securities contracts that are similar to the protections provided to FCMs in respect of commodity contracts and futures contracts. Section 555 of the Bankruptcy Code parallels, with respect to securities contracts, Section 556 of the Bankruptcy Code, permitting a stockbroker, financial institution, financial participant or securities clearing agency to exercise a "contractual right" to cause the liquidation, termination or acceleration of a securities contract based on a customer's bankruptcy or failed financial condition, and defining "contractual right" in a substantially similar manner.[514] Sections 362(b)(6) and 546(e) of the Bankruptcy Code apply to securities contracts as they do to commodity contracts and forward contracts, protecting the exercise of contractual rights to offset or net out any termination value, payment amount or other transfer obligations and rights under any security agreement or arrangement, or other credit enhancement, and preventing the trustee from avoiding margin payments and settlement payments made by or to an FCM in connection with a securities contract.

Unlike Section 566 of the Bankruptcy Code, Section 555 provides that it does not override a stay authorized by the provisions of SIPA. This limitation is discussed with respect to customers who are broker-dealers in Section XII.C below. Furthermore, Section 555 protects the exercise of rights only by stockbrokers, financial institutions, financial participants and securities clearing agencies, while Section 566 protects the exercise of rights by FCMs. A "stockbroker" includes any person with respect to which there is a "customer" and that is engaged in the business of effecting

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512 If the master agreement provides for both contracts that would be treated as "securities contracts" and for other types of transactions, then the agreement is considered to be a "securities contract" only with respect to each agreement or transaction under the master agreement that otherwise falls within the definition of "forward contract." 11 U.S.C. § 741(7)(A)(x).

513 *Id.* § 741(7)(xi).

514 *Id.* § 555. "[T]he term 'contractual right' includes a right set forth in a rule or bylaw of a derivatives clearing organization (as defined in the Commodity Exchange Act), a multilateral clearing organization (as defined in the Federal Deposit Insurance Corporation Improvement Act of 1991), a national securities exchange, a national securities association, a securities clearing agency, a contract market designated under the Commodity Exchange Act, a derivatives transaction execution facility registered under the Commodity Exchange Act, or a board of trade (as defined in the Commodity Exchange Act) or in a resolution of the governing board thereof and a right, whether or not evidenced in writing, arising under common law, under law merchant or by reason of normal business practice." *Id.*

transactions in securities for the account of others or with members of the public from or for such person's own account.[515] As noted in Section IV above, we have assumed that any FCM that enters into securities-based swaps that may be included in a portfolio margining arrangement would be a "stockbroker" for this purpose.

Because the SNCDS included in a portfolio margining arrangement are subject to the provisions of Section 4d(f)(2) of the CEA, such Portfolio-Margined SNCDS and the other cleared ~~swap contracts~~swaps carried in the customer's ~~customer~~ account would be liquidated as described in Section VII above, including by means of the BD/FCM being permitted to apply the customer funds held in the segregated account established under Section 4d(f)(2) of the CEA to the obligations arising under the Portfolio-Margined SNCDS carried for that customer. Similarly, the FCM would be required to deposit the funds received in respect of the Portfolio-Margined SNCDS carried for that customer in the segregated account, where they may be applied both to other SNCDS and to cleared ~~swap contracts~~swaps carried for that customer. In doing so, the FCM would effectively be applying proceeds of transactions that are protected by one safe harbor to obligations arising in respect of transactions protected by another safe harbor.[516] Moreover, to the extent that an FCM clears both U.S. futures ~~contracts~~ and cleared ~~swap contracts~~swaps for the same customer, although both classes of transactions would be subject to the same safe harbor, the FCM would be obligated to close out the two account classes separately, and then offset any proceeds of one account class against any deficit arising in respect of the other.

Section 561 of the Bankruptcy Code provides that the exercise of a contractual right to cause the termination, liquidation or acceleration of contracts falling under any of the Bankruptcy Code's safe harbors,[517] and the right to offset or net the termination values, payment amounts, or other transfer obligations arising under or in connection with one or more contracts falling under any of the safe harbors, will not be "stayed, avoided, or otherwise limited by operation of any provision of" the Bankruptcy Code.[518] Section 561 expressly protects the offset of claims and obligations arising under

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515 *Id.* § 101(53A).

516 Inclusion of a CDS in a 4d(f) account results in treatment of that account as a commodity account subject to the commodity broker insolvency provisions of the Code and to Part 190 of the CFTC's regulations. Dodd-Frank Act §713(c); *see also* Letter from Michael M. Philip, Partner, Winston & Strawn LLP, to Elizabeth M. Murphy, Sec'y, SEC (Nov. 7, 2011), *available at* https://www.sec.gov/rules/petitions/2011/petn4-641.pdf ("Congress, therefore, intended to provide customers trading cleared swaps with the same protections under the U.S. Bankruptcy Code afforded to customers trading exchange-traded futures in the event of an FCM insolvency.~~. .~~ . . . Section 713 authorizes the commingling of a customer's Security-Based Swaps with its cleared Swaps in a Section 4d(f) cleared Swap account and, provides that such account would not be deemed a securities account.").

517 In addition to commodity contracts, forward contracts, securities contracts and swap agreements (as discussed in Section XII.A.4 below), the Bankruptcy Code establishes safe harbors for repurchase agreements.

518 11 U.S.C. § 561(a).

a portfolio margining agreement or similar arrangement that has been approved by the CFTC under Section 5c(c)(1) or (Section 5c(c)(2) of the CEA.[519] "Contractual rights" are again defined very broadly to include not only a right, whether or not evidenced in writing, such as those established by the customer agreement, but also the full range of statutory rights, exchange and clearinghouse rules, and common law and practice.[520]

To ensure that the FCM's position is not disturbed after exercising its contractual rights to liquidate the customer transactions, the safe harbors applicable to commodity contracts and securities contracts protect the FCM from efforts by the trustee in bankruptcy to claw back the customer funds received by the FCM using its avoidance powers under the provisions described in Section XII.A.2 above. Section 548(d)(2)(D) of the Bankruptcy Code prevents the trustee from avoiding "constructive" fraudulent transfers[521] in relation to such contracts by providing that a commodity broker, forward contract merchant, financial institution, financial participant, or securities clearing agent that receives a margin payment or settlement payment with respect to a commodity contract or securities contract takes such payment "for value" to the extent of such payment.[522] As discussed above, the FCM will be a "commodity broker" and will generally also be "financial participants" for this purpose. Accordingly, the FCM will receive such transfers of collateral "for value" to the extent of such transfers, and such transfers will not be avoidable as constructive fraudulent transfers for purposes of Section 548(a)(2) of the Bankruptcy Code.

Furthermore, Section 546(e) of the Bankruptcy Code provides that the trustee may not avoid a margin payment or settlement payment made in respect of a commodity contract or securities contract by, to or for the benefit of a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant or securities clearing agency, or a transfer made by or to any such person in connection with a securities contract, commodity or forward contract, in each case made before the

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519 *Id.* § 561(a).

520 *Id.* § 561(c) ("'[C]ontractual right' includes a right set forth in a rule or bylaw of a derivatives clearing organization (as defined in the Commodity Exchange Act), a multilateral clearing organization (as defined in the Federal Deposit Insurance Corporation Improvement Act of 1991), a national securities exchange, a national securities association, a securities clearing agency, a contract market designated under the Commodity Exchange Act, a derivatives transaction execution facility registered under the Commodity Exchange Act, or a board of trade (as defined in the Commodity Exchange Act) or in a resolution of the governing board thereof, and a right, whether or not evidenced in writing, arising under common law, under law merchant, or by reason of normal business practice.").

521 That is, those transfers that are not made with intent to hinder, delay or defraud, but are made under specified circumstances if the debtor received less than a reasonably equivalent value ("*fair consideration*") in exchange for the transfer, addressed in 11 U.S.C. § 548(a)(1)(B). "Intentional" fraudulent transfers are not protected by the safe harbors. It should be noted that, as suggested by note 38, an "intentional" fraudulent transfer may be inferred from the existence of "badges of fraud" at the time of transfer, some of which may exist without actual intent to defraud on the part of the transferor.

522 *Id.* § 548(d)(2)(B).

commencement of the case, except under the provisions of Section 548 relating to "intentional" fraudulent transfers.[523] Thus, these transfers are further insulated from the trustee's powers to avoid preferences and fraudulent transfers and to exercise the "strong arm" power of Section 546.

Taking these provisions together, based on and subject to the assumptions and qualifications contained in this memorandum, the FCM would be permitted, notwithstanding the restrictions that would otherwise apply under the Bankruptcy Code, to liquidate the customer transactions, including U.S. futures ~~contracts~~, cleared ~~swap contracts~~swaps, and Portfolio-Margined SNCDS ~~included in any portfolio margining arrangement~~, and including instructing any foreign futures and options broker to liquidate any foreign futures ~~contracts~~ carried for the relevant customer; apply any margin held in the customer account in accordance with the CEA, the customer contract, DCO rules and CEA rules; offset any margin excess remaining with respect to any of such contracts against any margin deficit remaining with respect to any of such contracts; and return only the net balance remaining (if any) to the customer.

In addition to the protections established by the safe harbors in the Bankruptcy Code, the FCM may also be protected by the "netting" provisions of the Federal Deposit Insurance Corporation Improvement Act ("*FDICIA*~~").~~"),[524] FDICIA protects "netting" pursuant to contracts between financial institutions, and has been expanded over the years to protect the right of a "financial institution" to exercise termination, liquidation, acceleration and netting rights under "netting contracts" and to enforce related security agreements.

FDICIA applies only to contracts between "financial institutions." For this purpose, the term "financial institution" includes both those entities designated in the statute and those determined by the Federal Reserve Board. Under the statute itself, "financial institutions"[525] include registered broker-dealers,[526] depository institutions[527]

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523 *Id.* § 546(e). "Intentional" fraudulent transfers are not protected by the safe harbors. It should be noted that, as suggested by ~~footnote 6,~~note 37, an "intentional" fraudulent transfer may be inferred from the existence of "badges of fraud" at the time of transfer, some of which may exist without actual intent to defraud on the part of the transferor. *Id.* § 548(a)(1)(A).

524 12 U.S.C. § 4401 *et seq.* Although the title Federal Deposit Insurance Corporation Improvement Act applies to the entire statute, Pub. L. 102-242, 105 Stat. 2236 (Dec. 19, 1991), the term "FDICIA" is often used to refer only to the netting provisions contained in Subtitle A of Title IV of that Act, and that is the manner in which "FDICIA" is used in this memorandum.

525 *Id.* § 4402(9).

526 Defined as any company that is registered or licensed under Federal or State law to engage in the business of brokering, underwriting, or dealing in securities in the United States; and to the extent consistent with FDICIA, as determined by the Federal Reserve Board, any company that is an affiliate of a such a registered or licensed broker-dealer and that is engaged in the business of entering into netting contracts. *Id.* § 4402(1). We are not aware of any exercise by the Federal Reserve Board of its authority under this definition.

527 Defined to include most types of U.S. banking organizations, as well as U.S. branches and agencies of foreign banks and foreign banks that have U.S. branches and agencies. *Id.* § 4402(6).

and futures commission merchants.[528] Thus, the FCM will be a financial institution for this purpose. Many customers will not qualify as financial institutions under the statutory definition, but they may have been specifically designated as financial institutions by the Federal Reserve Board[529] or they may be treated as financial institutions pursuant to Regulation EE.[530] As currently in effect,[531] Regulation EE covers entities that are active as intermediaries in the financial markets, by classifying as financial institutions any person that represents, orally or in writing, that it will engage in financial contracts as a counterparty on both sides of one or more financial markets and meets one or both volume thresholds measured based on notional amount or mark-to-market value.[532]

If a person is a financial institution for this purpose, then FDICIA provides, among other things, that:

> (1) Notwithstanding any other provision of State or ~~Federal~~federal law, including any provision of the Bankruptcy Code, the "covered contractual payment obligations" and "covered contractual payment entitlements" between any two financial institutions shall be terminated, liquidated, accelerated, and netted in accordance with, and subject to the conditions of, the terms of any applicable "netting contract."[533]
>
> (2) The only obligation, if any, of a financial institution to *make* payment with respect to any such covered contractual payment obligations to another financial institution will be equal to its net obligation to such other financial institution, the only right, if any, of a financial institution to *receive* payments with respect to covered contractual payment entitlements from another financial institution will be equal to its net entitlement with respect to such other financial institution, and the net entitlement of any failed financial institution, if any, must be paid to the failed financial institution in accordance with, and subject to the conditions of, the applicable netting contract.[534]
>
> (3) The provisions of any security agreement or arrangement or other credit enhancement related to any netting contract between any two financial

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528 Defined as any company that is registered or licensed under Federal law to engage in the business of selling futures and options in commodities. *Id.* § 4402(10).

529 The Federal Reserve Board may designated any other institution as a financial institution for purposes of FDICIA. *Id.* § 4402(9).

530 12 C.F.R. § 231 (2020).

531 The Federal Reserve Board has proposed rules that would significantly expand the categories of institutions that would be treated as financial institutions for purposes of FDICIA. Netting Eligibility for Financial Institutions, 84 Fed. Reg. 18,741 (May 2, 2019) (to be codified at 12 C.F.R. pt. 231).

532 12 C.F.R. § 231.3 (2020).

533 12 U.S.C. § 4403(a). There are exceptions to this blanket override in some of the other insolvency regimes discussed below; those exceptions will be discussed in the relevant section of this memorandum.

534 *Id.* § 4402(b), (c) & (d).

institutions will be enforceable in accordance with their terms, and may not be stayed, avoided, or otherwise limited by any State or ~~Federal~~federal law.

If both the FCM and the customer are "financial institutions" for purposes of this statute, then FDICIA would protect the FCM's rights against the customer to the extent that they arise under a "netting contract." For this purpose, a "netting contract" means "a contract or agreement between 2 or more financial institutions .~~.~~ . . that provides for netting present or future payment obligations or payment entitlements (including liquidation or close out values relating to such obligations or entitlements) among the parties to the agreement." We have assumed that each customer agreement provides for the FCM's right to net any deficit arising in respect of one class of customer transactions against any balance due in respect of any other class of customer transactions, and believe that this right constitutes a right to net present payment entitlements as referred to in the definition of "netting contract." As a result, the FCM's right to exercise liquidation and netting rights and to enforce related security arrangements is protected by FDICIA, as well as by the safe harbors contained in the Bankruptcy Code itself.

It should be noted that, if an FCM chooses not to exercise the rights described above, the trustee in bankruptcy may exercise its rights to reject, assume or assign the relevant customer transactions as described in Section XII.A.2(iii) above.

4. Safe Harbors as Applied to Cross-Affiliate Netting

If an uncleared swaps affiliate has a perfected security interest in a customer's ~~customer~~ account with an affiliated FCM, the uncleared swaps affiliate would generally have the contractual right to foreclose upon the proceeds of the customer's ~~customer~~ account, subject to the rights of the FCM under the customer agreement and applicable law. However, the uncleared swaps affiliate's right to take such action, even after the satisfaction of the customer's obligations to the FCM, would also be subject to the limitations imposed by the Bankruptcy Code but for the safe harbors established for "swap agreements," another category of financial contracts given special status under the Bankruptcy Code.

Swap agreements include:

- any rate swap agreement, basis swap, forward rate agreement, commodity swap, interest rate option, forward foreign exchange agreement, spot foreign exchange agreement, rate cap agreement, rate floor agreement, rate collar agreement, currency swap agreement, cross-currency rate swap agreement, currency option, any other similar agreement (including any option to enter into any of the foregoing);

- any combination of the foregoing; and

- any master agreement for any of the foregoing together with all supplements.[535]

As noted in Section IV above, we have assumed that all uncleared swaps under the uncleared swaps agreement are "swap agreements" within the meaning of the Bankruptcy Code.

As noted above, the powers of a trustee in bankruptcy permit the trustee in bankruptcy to avoid a number of pre- and post-petition transfers made by the debtor or involving its property, and impose a number of limits on the rights of creditors following the commencement of a proceeding. However, as is the case with respect to cleared transactions, such as the customer transactions, the Bankruptcy Code includes safe harbors for swap agreements as well.

Section 560 permits the uncleared swaps affiliate to exercise any right that it may have to terminate the uncleared swap and uncleared swaps agreement as a result of a default arising out of the customer's commencement of a bankruptcy proceeding, insolvency or financial condition, notwithstanding the anti-*ipso facto* provisions of Section 365(e)(1),[536] and Section 362(b)(17) permits the exercise of any contractual right to offset or net out any termination value, payment amount or other transfer obligation arising under or in connection with any such agreements notwithstanding the automatic stay.

As is the case with respect to commodity contracts and securities contracts, parties to swap agreements are also protected from the trustee's avoidance powers. Section 548(d)(2)(D) of the Bankruptcy Code prevents the trustee from avoiding "constructive" fraudulent transfers[537] by providing that a swap participant that receives a transfer in connection with a swap agreement takes the transfer for value to the extent of such transfer. With respect to transfers made by the customer to the uncleared swaps affiliate pursuant to the uncleared swaps agreement, including both payments and deliveries of margin, the uncleared swaps affiliate will be a "swap participant" for

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535 11 U.S.C. § 101(53B).

536 To the extent that the uncleared swaps affiliate has a termination right arising from a cross-default under the customer agreement relating to ~~cleared customer~~ transactions, we assume that such right would be exercised prior to the commencement of the customer's bankruptcy proceeding, and that any termination arising after the customer's commencement of the bankruptcy proceeding would be based on the financial condition or insolvency of the customer or its commencement of such a proceeding.

537 ~~That is, those transfers that are not made with intent to hinder, delay or defraud, but are made under specified circumstances if the debtor received less than a reasonably equivalent value ("*fair consideration*") in exchange for the transfer, addressed in 11 U.S.C. § 548(a)(1)(B). "Intentional" fraudulent transfers are not protected by the safe harbors. It should be noted that, as suggested by footnote 6, an "intentional" fraudulent transfer may be inferred from the existence of "badges of fraud" at the time of transfer, some of which may exist without actual intent to defraud on the part of the transferor.~~ *See supra* note 521.

purposes of this provision,[538] the uncleared swaps affiliate will receive such transfers in connection with a swap agreement between the uncleared swaps affiliate and the customer, and, accordingly, the uncleared swaps affiliate will receive such transfers of collateral "for value" to the extent of such transfers. Thus, such transfers will not be constructive fraudulent transfers for purposes of Section 548(a)(2) of the Bankruptcy Code.

Section 546(g) of the Bankruptcy Code provides that, notwithstanding Sections 544, 545, 547, 548(a)(1)(B) and 548(b) of the Bankruptcy Code, a trustee may not avoid a transfer, made by, to or for the benefit of a swap participant or financial participant, under or in connection with a swap agreement and that is made before the commencement of the case, except for a transaction that is voidable as an "intentional" fraudulent transfer under Section 548(a)(1). The legislative history of the swap agreement safe harbor makes clear that Section 546(g) of the Bankruptcy Code was intended to provide "the same exemption from the Bankruptcy Code's automatic stay and trustee avoidance provisions to interest rate and foreign currency rate swap agreements that current law provides to other similar types of financial agreements, including repurchase agreements, securities contracts, commodities contracts, and forward contracts."[539] Accordingly, Section 546(g) would prohibit the trustee from avoiding transfers of collateral made prior to the customer's bankruptcy proceeding, including the pledge of the amounts due to the customer from the FCM under the customer agreement, because that transfer would be made in connection with a swap agreement between the customer and the uncleared swaps affiliate.

If the customer is a "financial institution" for purposes of FDICIA, then FDICIA would also protect the right of the uncleared swaps affiliate to apply the amounts payable by the FCM to the customer as collateral to the obligations of the customer under the uncleared swaps agreement. As noted in Section IV above, we have assumed that the uncleared swaps agreement includes netting provisions of the type included in the 1991 ISDA Master Agreement, and therefore qualifies as a "netting contract" under 12 U.S.C. § 4402. As a result, FDICIA would permit the uncleared swaps affiliate to exercise its termination rights under the uncleared swaps agreement, liquidate and apply the collateral (including the amounts due from the FCM), net the payment obligations of the two parties arising from the foregoing, and pay or receive only the net amount due to or from the customer.

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538 A "swap participant" is "an entity that, at any time before the filing of the petition, has an outstanding swap agreement with the debtor." 11 U.S.C. § 101(53C).

539 H.R. REP. NO. 484, 101st Cong., 2d Sess., *reprinted in* 1990 U.S.C.C.A.N. 223, 223; *see also* S. REP. NO. 285, 101st Cong., 2d Sess. (1990), *reprinted in* 281 Bankr. L.R. (CCH) 1, 10 (Senate bill would "add[] a new subsection 546(g) to extend similar protections against the trustee's avoiding powers for transfers or payments under a swap agreement").

5. Safe Harbors as Applied to an FCM's Cross-Affiliate Netting

Similar to the uncleared swaps affiliate's right to foreclose on a swaps agreement, the FCM's right to foreclose on and exercise a security interest in the assets held by the uncleared swaps affiliate would be limited absent the safe harbor provisions of the Bankruptcy Code. The Bankruptcy Code includes safe harbors for security arrangements.

Section 556 of the Bankruptcy Code permits the FCM to exercise any right that it may have to terminate the securities contract and its right to receive margin payment as a result of a default arising out of the customer's commencement of a bankruptcy proceeding, insolvency or financial condition, notwithstanding the anti-*ipso facto* provisions of Section 365(e)(1).[540] Section 362(b)(6) permits the exercise of any contractual right so defined under Section 556, including the right to offset or net out any termination value, payment amount or other transfer obligation arising under, or in connection with, any such contracts, including any master agreement for such contracts, notwithstanding the automatic stay provided in Section 362(a).[541] Section 548(d)(2)(B) provides further protection of the FCM's right to receive margin payment by providing that an FCM that receives a margin payment or settlement payment as defined in the Bankruptcy Code takes for value to the extent of such payment. Because Section 548(d)(2)(B) includes "settlement payment," the FCM can foreclose on collateral that was not margin and apply the proceeds to a defaulting customer's obligation.

Section 546(e) of the Bankruptcy Code provides that, notwithstanding Sections 544, 545, 547, 548(a)(1)(B) and 548(b) of the Bankruptcy Code, a trustee may not avoid a transfer that is a margin payment or settlement payment, made by or to (or for the benefit of) an FCM, or that is a transfer made by or to (or for the benefit of) an FCM in connection with a securities contract, that is made before the customer's bankruptcy proceeding, except for a transaction that is voidable as an "intentional" fraudulent transfer under Section 548(a)(1). Accordingly, Section 546(e) prohibits the trustee from avoiding transfers of collateral made prior to the customer's bankruptcy proceeding, including the margin payment or settlement payments due to the FCM from the cross-affiliate under the customer agreement, because that transfer would be made in connection with a securities agreement between the customer and the FCM.

B. Customers Who Are Commodity Brokers Liquidated Under Subchapter IV of Chapter 7

Subchapter IV of Chapter 7 establishes special provisions governing the liquidation of a "commodity broker," as discussed below. These provisions are supplemented by Part 190 of the CFTC's regulations, which have been adopted pursuant

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540 *See* 11 U.S.C. § 556.

541 *See id.* §§ 362(a), 362(b)(6).

to the CFTC's authority to define what is "customer property," the conduct of the business of the commodity broker after the commencement of a bankruptcy proceeding and related matters.[542] While the discussion in XII.A generally applies to such proceedings, there are several differences reflecting the need to protect the customers of such failed commodity broker, both by ensuring that the customer transactions and customer property of the customers of that failed commodity broker are not applied to the commodity broker's own debts, and to facilitate the transfer of customer transactions and customer property to a solvent commodity broker when so directed by the CFTC.

1. Entities Covered by Subchapter IV of Chapter 7 of the Bankruptcy Code

Subchapter IV of Chapter 7 of the Bankruptcy Code establishes liquidation provisions applicable to failed commodity brokers. For this purpose, a "commodity broker" is a "futures commission merchant, foreign futures commission merchant, clearing organization, leverage transaction merchant, or commodity options dealer, as defined in section 761 of this title, with respect to which there is a customer, as defined in section 761 of this title."[543] A "customer" is an entity for or with whom such a person deals and that holds a claim against such person on account of a commodity contract.[544] Accordingly, this Section- XII.B addresses any customer that is itself a futures commission merchant, foreign futures commission merchant (to the extent subject to the Bankruptcy Code), leverage transaction merchant or commodity options dealer with respect to which there are entities for or with whom such party deals and that holds a claim against such party on account of a commodity contract.[545]

2. Restrictions and Powers of the Trustee Where Customer Is a Commodity Broker Liquidated Under Subchapter IV

Both the powers of the trustee, and the safe harbors, discussed in Section- XII.A above also apply in a liquidation proceeding for a commodity broker under Chapter 7.[546] However, as noted above, the application of the safe harbors are

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542 7 U.S.C. § 24(a).

543 11 U.S.C. § 101(6).

544 *Id.* § 761(9)(A).

545 This memorandum does not address customers that are clearing organizations.

546 We note that many FCMs are also broker-dealers subject to liquidation under SIPA. In that case, SIPA provides that, "[t]o the extent consistent with the provisions of this chapter .~~..~~ . . , [the] trustee shall be subject to the same duties as a trustee in a case under chapter 7 of title 11, including, if the debtor is a commodity broker, as defined under section 101 of such title, the duties specified in subchapter IV of such chapter 7, except that a trustee may, but shall have no duty to, reduce to money any securities constituting customer property or in the general estate of the debtor." 15 U.S. Code § 78fff–1(b). The interaction between the commodities liquidation provision of subchapter IV and Part 190 and the securities liquidation provision of SIPA, and the extent to which they may be deemed "consistent," has been the subject of recent discussion. On October 30, 2019, the House Agriculture Committee approved H.R. 4895, a bill to reauthorize the CFTC. H.R. 4895, 116th Cong. (2019). The reauthorization amends Section 20(a) of the CEA in

limited in several respects intended to protect the customer transactions and property carried by the failed commodity broker, and to permit the trustee in bankruptcy to transfer such customer transactions pursuant to the CFTC's Part 190 regulations ("*Part 190*~~").~~").[547]

(i) *Right to Net or Offset Limited by Positive Net Equity Requirement and Existing Customer Obligations*

An FCM's contractual right to net or offset its obligations to a customer that is commodity broker in default may be limited by Section 561(b)(2) of the Bankruptcy Code. Although Section 561 generally provides for a counterparty's ability to exercise termination, liquidation, setoff and other rights under a master agreement and across categories of safe harbored transactions, as described in Section XII.A.3 above, Section 561(b)(2) provides, specifically in respect to commodity brokers, that:

> (a) A party may not set off an obligation to the failed commodity broker arising under, or in connection with, a cleared customer transaction against any claim against the failed commodity broker arising under, or in connection with, any other category of safe harbored contracts, *except* to the extent that the party has positive net equity in the commodity accounts at the debtor. In other words, any positive net equity in the failed commodity broker's commodity account with the FCM may be applied to the failed commodity broker's other safe harbored contracts, but cross-product netting cannot create a deficit in the failed commodity broker's customer account.
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> (b) In addition, another commodity broker may not set off an obligation to the failed commodity broker arising under, or in connection with, a cleared customer transaction entered into or held on behalf of a customer of the failed commodity broker against any claim arising under, or in connection with, any other safe-harbored transactions.

Section 561(b)(2)(A) would not interfere with or limit the ability of an FCM to liquidate the failed commodity broker's ~~cleared customer~~ transactions (*i.e.*, U.S. futures ~~contracts~~ and cleared ~~swap contracts~~swaps) and its segregated customer assets in accordance with CFTC regulations, including Part 190. Similarly, it would not interfere

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order to provide "for the broad use of the assets of a commodity broker's estate, other than secured property (such as property held at a clearinghouse, including offset or netting rights of creditors with respect to such type of property), to satisfy shortfalls in customer property beyond what was held in customer segregated accounts at the time of a firm's failure." H.R. REP. NO. 116-313, § 119, at 31 (2019). This eliminates the doubt as to the validity of Regulation 190.08(a)(1)(ii)(J) that arose in 2000 after a federal bankruptcy court rejected an attempt by the trustee in that case to use a bankrupt commodity broker's estate to pay shortfalls in the customer accounts. *In re Griffin Trading Co*., 245 B.R. 291, 296 (Bankr. N.D. Ill. 2000), *vacated*, 270 B.R. 882 (Bank. N.D. Ill 2001). Thus, assuming this bill is enacted, the commodities liquidation provision of subchapter IV and Part 190 would be consistent with those of SIPA with respect to FCMs who are broker-dealers subject to liquidation.

547 17 C.F.R. § 190 (2020).

with the liquidation of, or offset of amounts owing in relation to, all other types of safe harbored transactions against one another, including foreign futures. However, the FCM could not offset other customer transactions, including foreign futures ~~contracts~~ traded on a contract market or derivatives transaction execution facility that has not been designated or registered with the CFTC, against the failed commodity contracts ~~cleared customer~~ transactions.

Similarly, Section 561(b)(2)(A) would not preclude the offset of amounts relating to proprietary contracts carried for the failed commodity broker against other safe-harbored contracts executed by the failed commodity broker for its own account. Rather, it would limit the ability of an FCM to offset amounts owing in relation to *customer* transactions carried by the failed commodity broker.

Portfolio-Margined SNCDS – *i.e.*, those carried as part of an approved portfolio margining arrangement – are exempt from these limitations. Section 561(b)(3) provides that Sections 561(b)(2)(A) and (B) will not prohibit the offset of claims and obligations that arise under a portfolio margining agreement or similar arrangement that has been approved by the CFTC or submitted to the CFTC Section 5c(c) of the CEA and not abrogated or rendered ineffective by the CFTC.[548] Accordingly, Section 561(b)(2) would not interfere with the liquidation of a customer account for a failed commodity broker that has engaged in portfolio margining in the manner described in Section VIII above.

(ii) *Transfer Pursuant to Part 190*

Part 190 may also limit the ability of an FCM to exercise remedies against a failed commodity broker. The aim of Part 190 is to transfer all open customer commodity contracts carried by the failed commodity broker to a solvent FCM to the extent possible. Accordingly, the trustee in bankruptcy for the failed commodity broker is required to immediately use its best efforts to effect a transfer of all open commodity contracts and equity held by the commodity broker for or on behalf of its customers.[549] If a transfer of all customer transactions cannot be completed, then the trustee in bankruptcy is permitted to liquidate enough of a customer's transactions to generate sufficient equity to permit the transfer of the remainder.[550] Then, open commodity contracts, specifically

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548 Section 561(b)(3) also protects "any other netting agreement between a clearing organization (as defined in section 761) and another entity that has been approved by the Commodity Futures Trading Commission."

549 17 C.F.R. § 190.~~02(c) (2020~~04(a)(1).

550 *Id.* § 190.~~06(f)(3~~07(d)(2)(ii) ("If all of a customer's open commodity contracts cannot be transferred under this section, a partial transfer of contracts and property may be made. ~~A~~. . One, but not the only, means to effectuate a partial transfer ~~may be effected~~is by liquidating ~~that~~a portion of the open commodity contracts held by a customer ~~which represents~~ such that sufficient ~~equity~~value is realized, or margin requirements are reduced to an extent sufficient, to permit the transfer of some or all of the ~~remainder. If any~~remaining open commodity contracts and property. If any open commodity contract to be transferred in a partial transfer ~~are~~is part of a spread or

identifiable property, and all other property held by or for the account of the failed commodity broker must be liquidated or offset by the trustee promptly and in an orderly manner.[551]

Part 190 does not attempt to override the safe harbors contained in the Bankruptcy Code when applied to a failed FCM in its capacity as a customer.[552] As a result, it appears that an FCM may exercise its remedies, in accordance with the safe harbors, against the failed commodity broker.

C. Customers Subject to SIPA

1. Entities Covered by SIPA

Brokers and dealers are subject to the Bankruptcy Code, but the application of the Bankruptcy Code to registered broker-dealers normally will be superseded by SIPA. SIPA and Chapter 7 of the Bankruptcy Code establish special provisions applicable to the insolvency of a broker or dealer that carries customer accounts insured by the SIPC (*i.e.*, most broker-dealers doing business in the U.S.).[553]

SIPC may commence a proceeding under SIPA if a broker-dealer has failed or is in danger of failing to meet its obligations to customers, and the broker-dealer is insolvent, a receiver, trustee or liquidator for the broker-dealer has been appointed, or the broker-dealer is not in compliance with the regulations of the SEC regarding financial responsibility or hypothecation of customer securities or cannot demonstrate its compliance with those requirements.[554] The SIPA proceeding supersedes any Bankruptcy Code case relating to that broker-dealer.

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straddle, ~~both sides~~ to the extent practicable under the circumstances, each side of such spread or straddle must be transferred or ~~neither side~~ none of the open commodity contracts comprising the spread or straddle may be transferred."). *See also* Kathryn M. Trkla, Commodity Broker Bankruptcies and the ABA Part 190 Project, BUS. L. TODAY (Dec. 2017), *available at* https://businesslawtoday.org/wp-content/uploads/2018/01/K.-Trkla-CLE-Paper-ABA-Winter-Meetting.pdf.

551 17 C.F.R. § 190.~~02(f) (2020~~04(d).

552 Part 190 does provide that, to the extent the failed commodity broker, does not have sufficient property to satisfy all customer claims, then customer property relating to any account class (futures; foreign futures; cleared swaps; and delivery account classes) may be shared only by customers of that account class. *Id.* § 190.09(c)(1). This does not appear to affect the rights of the brokers that carry the contracts falling within the different account classes.

553 SIPA § 3(a)(2); 15 U.S.C. § 78ccc(a)(2). Limited purpose broker-dealers under the SEC's regime for "OTC derivatives dealers" are not subject to SIPA. 17 C.F.R. § 240.36a1-2 (2020). On July 24, 2020, the SEC and FDIC adopted a rule, pursuant to the Dodd-Frank Act, to clarify and implement provisions related to the orderly liquidation of covered broker-dealers. Covered Broker-Dealer Provisions Under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Exchange Act Release No. 34-89394, 85 Fed. Reg. 53,645 (Aug. 31, 2020) (to be codified at 12 C.F.R. pt. 302).

554 SIPA § 5(a)(3); 15 U.S.C. § 78eee(a)(3).

A liquidation proceeding under SIPA or under Chapter 7 of the Bankruptcy Code is conducted in a manner similar to a proceeding under other portions of the Bankruptcy Code, except that both contain provisions intended to ensure that "customer property" held by the broker or dealer is returned to or applied to claims of customers, together with other assets of the broker-dealer, if necessary. The court conducting a SIPA proceeding has all the powers and duties conferred upon a bankruptcy court under the Bankruptcy Code, together with the additional powers and duties established by SIPA.[555] Moreover, SIPA provides that "[t]o the extent consistent with the provisions of this chapter, a liquidation proceeding shall be conducted in accordance with, and as though it were being conducted under .~~.~~ . . subchapters I and II of chapter 7 of [the Code]."[556]

2. Restrictions and Powers of the SIPA-Appointed Trustee

Upon the filing of an application for a protective decree under SIPA, the court hearing the application is required to issue a stay of all pending bankruptcy or insolvency proceedings, and may also stay any proceeding to enforce a lien against property of the debtor or any other suit against the debtor. However, the stay does not abrogate any right of setoff, except to the extent such right may be affected under section 553 of the Bankruptcy Code as described above. Upon the issuance of a protective decree, the court must forthwith appoint a trustee (a "*SIPA trustee*~~")~~") for the liquidation of the business of the debtor and order the removal of the entire liquidation proceeding to the bankruptcy court in the same judicial district.[557] This SIPA trustee is subject to the duties of a trustee under Chapter 7 of the Code, including those specified in Subchapter IV's provisions for insolvent commodity brokers.[558]

Section- 78eee(b)(2) of SIPA permits SIPC to impose a stay on many actions against a failed broker-dealer, as discussed above. However, Section- 78eee(b)(2)(C)(i) of SIPA provides that neither the filing of an application to commence a SIPA proceeding nor an order or decree issued by a court under SIPA will "operate as a stay of any contractual rights of a creditor to liquidate, terminate, or accelerate a securities contract, commodity contract, forward contract, repurchase agreement, swap agreement, or master netting agreement as those terms are defined in [the Bankruptcy Code], to offset or net termination values .~~.~~ . . in connection with one or more of such contracts .~~.~~ . . , or to foreclose on any *cash collateral* pledged by the

555 15 U.S.C. § 78eee(b)(2)(A)(iii).

556 *Id.* § 78fff(b).

557 *Id.* §- 78eee(b)(3)-(4).

558 *Id.* §- 78fff-1(b).

debtor."[559] Thus, SIPA provides the same exception to the automatic stay for contracts that fall under the Bankruptcy Code's safe harbors.

However, Section 78eee(b)(2)(C)(ii) states that such an application or order *may* function as a stay of the foreclosure upon, or disposition of, *securities collateral* pledged by the debtor. In previous cases,[560] SIPC has sought such a stay on exercising any right of setoff or enforcing liens or pledges with respect to such collateral for 21 days, until it can determine that the securities are not necessary to satisfy customer claims in the connection with the liquidation of the broker-dealer.

Additionally, SIPC has stated that its standard form of stay order proposed at the commencement of a SIPA proceeding will bar the immediate close out of securities lending transactions with the debtor firm, but will permit such transactions that are "securities contracts" with protected parties to be closed out upon consent of SIPC and the trustee appointed in the proceeding without requiring court relief. This consent should be premised upon an affidavit and supporting documentation from the securities lender stating that it has no knowledge of fraud and that it has a perfected security interest in the subject collateral. This consent could be made in as soon as four or five days.[561]

SIPC has also modified its standard form of stay order to allow close outs of repurchase agreements regardless of whether the repurchase agreements fit the definition of "repurchase agreements" under the Bankruptcy Code. SIPC has indicated that it will ask a court to except from the SIPA stay the close out of a repurchase agreement when the SIPC member is a repo buyer. Additionally, SIPC has stated that it would consent to the close out of repos and securities lending transactions not only if the SIPC counterparty has a perfected security interest in the assets, but also if the SIPC counterparty has the rights of an owner of the assets received in the transaction, and regardless of whether the SIPC member is a borrower or a lender.[562]

3. Safe Harbors as Applied to Liquidation of Commodity Contracts and Swaps

As discussed above, SIPA provides for an exception to the automatic stay for contracts that fall under the Bankruptcy Code's safe harbors. To be eligible for this protection, each of the contracts in question must be a "securities contract, commodity contract, forward contract, repurchase agreement, swap agreement, or master netting agreement" as defined in the Bankruptcy Code.[563] One key difference is that, unlike the

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559 *Id.* § 78eee(b)(2)(C)(i) (emphasis added). The term "contractual right" includes "a right set forth in a rule or bylaw of a derivatives clearing organization (as defined in the Commodity Exchange Act [7 U.S.C. 1 *et seq.*])." *Id.* § 78eee(b)(2)(C)(iii).

560 *See, e.g.*, *SIPC* v. *MF Global Inc.*, No. 11-Civ.-7750 (S.D.N.Y. Oct. 31, 2011); *SIPC* v. *Lehman Brothers Inc.*, No. 08-Civ.-8119 (S.D.N.Y. Sept. 19, 2008).

561 *See* 5 Collier on Bankruptcy ¶ 555.04 at 555-16, ~~footnote~~ n.7.

562 *Id.*

563 *See* 15 U.S.C. § 78eee(b)(2)(C)(i).

safe harbors in the Bankruptcy Code, SIPA does not limit the counterparty types that may exercise these protected rights to net or offset notwithstanding the automatic stay.[564] In addition, as discussed in Section- XII.C.2, SIPA does permit the trustee to stay the liquidation of securities collateral, including securities posted as margin under a commodities contract, and SIPA has exercised this power in prior broker-dealer liquidations.

D. Customers Subject to the Federal Deposit Insurance Act

As noted in Section- XII.A.1 above, the Bankruptcy Code excludes as debtors most types of U.S. banks, as well as foreign banks that maintain branches or agencies in the U.S. In keeping with the "dual banking" system of the United States, in which banking entities may be chartered or licensed by either ~~Federal~~federal or state authorities under either ~~Federal~~federal or state law, insolvency proceedings relating to a failed bank were historically governed by the law of the jurisdiction under which the bank was chartered. In principle, this remains true: the receivership provisions of the National Bank Act[565] and the conservatorship provisions of the Bank Conservation Act[566] establish a framework for proceedings to resolve an insolvent national bank (*i.e.*, a bank chartered under the National Bank Act), and the laws of individual states include frameworks for proceedings to resolve state-chartered banks chartered under the laws of the applicable state.

However, if a bank's deposits are insured by the FDIC, then the insolvency provisions of the FDIA will also apply. When the FDIC was established in 1933, its powers with respect to insolvent banks were relatively limited,[567] but in the years since, the FDIC's powers have grown extensively, and to a significant extent, the provisions of the FDIA and the FDIC's powers as receiver or conservator predominate over the provisions of the "primary" federal or state law.

When the FDIC is appointed as receiver, it is generally expected to liquidate the assets of the insolvent depository institution and to wind up its affairs. When it is appointed as conservator, it is generally expected to attempt to restore the institution to financial health and to return it to normal operation.[568] Today, the conservatorship powers are rarely utilized, because the FDIC, as receiver, has the power to establish a

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564 *Id*. Any SNCDS that are held in 4d(f) accounts as part of SNCDS margining programs pursuant to the 2012 SEC Exemptive Order and CFTC ICE Clear Credit Order are afforded protection under the CEA and related laws, and are not covered by SIPA. *See* 2012 SEC Exemptive Order, *supra* note 211, at 75217; CFTC ICE Clear Credit Order, *supra* note 201, at 3.

565 Chapters 1 and 2 of Title 12 of the U.S. Code.

566 12 U.S.C. §§- 201-12.

567 *See* Banking Act of 1933, Pub. L. 73-66, 48 Stat. 162 (1933).

568 *Cf.* 12 U.S.C. § 1821(d)(2)(D), (E).

temporary successor depository institution, or "bridge bank," to assume the deposits and certain operations of the failed depository institution.[569]

1. Entities Covered by the FDIA

All depository institutions[570] that accept deposits that are insured by the FDIC are subject to the FDIA, including the extensive provisions relating to the liquidation or conservation of insured depository institutions. The FDIC can become involved in a depository institution insolvency in two ways: either the applicable chartering authority or the primary federal regulator of the failing depository institution may appoint the FDIC as conservator or receiver for the depository institution, or the FDIC may appoint itself as conservator or receiver of a bank with respect to any insured depository institutions.[571] It is possible, under the Bank Conservation Act and under some state statutes, for a person other than the FDIC to be appointed in respect of a failed depository institution, but this has not occurred in practice in recent years and, if it were to happen, it is almost certain that the FDIC would have the authority to appoint itself in place of the person appointed.[572]

If the FDIC is appointed as conservator or receiver for a national bank, the FDIC will have both the powers granted to the FDIC by the FDIA, and, to the extent not inconsistent with the FDIA, the powers granted to conservators or receivers of national banks.[573] If a state chartering authority appoints the FDIC as receiver for a state-chartered bank, the FDIC will have both the powers granted to receivers by the applicable state law *and* the powers granted to the FDIC by the FDIA.[574] If the FDIC appoints itself as conservator or receiver for an insured state-chartered bank, or if the appropriate ~~Federal~~federal banking agency appoints the FDIC as conservator or receiver for such a bank, the FDIC's powers are the same as if the bank were a national bank.[575]

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569 *See* 12 U.S.C. § 1821(n).

570 "Depository institutions" include both "banks" and "savings associations."

571 The Comptroller of the Currency is given the authority to appoint a receiver, and the FDIC is authorized to accept appointment as a receiver, for a national bank under 12 U.S.C. §§ 191 and 1821(c). State statutes may authorize the relevant state authority to appoint a receiver for a bank chartered under the laws of the relevant state; in New York, the New York Superintendent of Banks has the authority to take possession of a New York-chartered bank and appoint a receiver for its property pursuant to NYBL § 606(1), and the FDIC has authority to accept appointment as receiver pursuant to 12 U.S.C. § 1821(c)(3)(A). In addition, the primary federal regulator of the bank also may appoint the FDIC as receiver or conservator for the bank if the bank is "undercapitalized" or if necessary to implement the FDIA's "prompt corrective action" provisions. 12 U.S.C. § 1821(c)(9). In certain circumstances, the FDIC can also appoint itself as conservator or receiver for a bank. *Id.* § 1821(c)(10).

572 *Id.* § 1821(c)(10).

573 *Id.* §§ 203(d), 1821(c)(2)(B).

574 *Id*. § 1821(c)(3)(B).

575 *Id.* § 1821(c)(13).

2. Powers of the FDIC as a Receiver or Conservator

If the FDIC is appointed as conservator or receiver, the FDIC succeeds to all rights, titles, powers, and privileges of the insured depository institution and its stockholders, members, account holders, depositors, officers, or directors.[576] The FDIC, as conservator or receiver, may take over the assets of, operate, and perform all functions of the institution in the name of the institution which are consistent with its appointment as conservator or receiver.[577] Absent the special treatment of QFCs as discussed below, the commencement of a proceeding against a customer under the FDIA would give the FDIC as conservator or receiver the authority to invalidate or reverse certain transactions that occurred between the FCM and the defaulting customer prior to the commencement of the proceeding, and limit the FCM's ability to exercise its contractual rights against the defaulting customer.

(i) *Avoidance of Pre-Petition Transfers*

The FDIA does not contain independent "preference" provisions that apply to transfers of assets by the insolvent institution. However, the FDIC can avoid preferential transfers to the extent provided in the ~~NBA~~National Bank Act or the NYBL, as applicable.

Under Section 91 of the ~~NBA~~National Bank Act, any payment or transfer of assets by a national bank to its shareholders or creditors "made after the commission of an act of insolvency, or in contemplation thereof, made with a view to prevent the application of its assets in the manner prescribed by this chapter, or with a view to the preference of one creditor to another ~~,~~ . . shall be utterly null and void."[578] Furthermore, Section 194 of the ~~NBA~~National Bank Act requires the receiver appointed by the OCC to distribute the proceeds of the liquidation of a national bank "ratabl[y]" to creditors.[579] These provisions may invalidate transfers made after an act of insolvency or in contemplation of insolvency, whether or not the recipient of the transfer had any knowledge of the act or contemplation of insolvency or had any intention to be preferred.[580]

A national bank is "in contemplation of insolvency" when "the fact becomes reasonably apparent to its officers that it will presently be unable to meet its obligations, and will be obliged to suspend its ordinary operations."[581] "Acts of insolvency" include the adoption by the directors of a bank of a resolution to suspend its

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576 *Id.* § 1821(d)(2)(A).

577 *Id.* § 1821(d)(2)(B).

578 *Id.* § 91.

579 *Id.* § 194. *See Texas American Bancshares, Inc.* v. *Clarke*, 954 F.2d 329 (5th Cir. 1992).

580 *National Security Bank* v. *Butler,* 129 U.S. 223, 231 (1889); *Aycock* v. *Bradbury*, 77 F.2d 14, 17 (10th Cir. 1935); 109 A.L.R. Fed. 247, 265.

581 *Armstrong* v. *Chemical Nat'l Bank*, 41 F. 234 (C.C.S.D.N.Y. 1890); *accord Fed. Deposit Ins. Corp.* v. *Goldberg*, 906 F.2d 1087, 1091 (5th Cir. 1990); *Aycock* v. *Bradbury*, 77 F.2d at 17.

operations, a failure by the bank to pay a deposit on demand or to meet its obligations at maturity, an admission by the bank or its officers that it is unable to satisfy its obligations when due or the appointment of a receiver or conservator for the bank. Any transfer occurring after such an act, or when the officers know that insolvency cannot be avoided, is void if it would result in a transfer that is not in accordance with the liquidation procedures of the ~~NBA~~National Bank Act or would prefer one creditor over another. Because the parties dealing with the bank may be completely unaware when these acts occur, this preference power can put parties dealing with a troubled bank at substantial risk.

State laws may or may not contain similar provisions. For example, the NYBL does not contain a provision comparable to Section 91 of the ~~NBA~~National Bank Act. Nonetheless, the policy of the statute is to ensure a ratable distribution of assets to creditors of the insolvent institution, subject to preferences and priorities established or recognized under the NYBL.[582] Accordingly, it is possible that a court might permit a conservator or receiver of a New York bank to avoid a transfer of the property of a New York bank if that transfer were made after the insolvency of the New York bank and with the purpose or effect of preferring one creditor over another.

The FDIA, ~~NBA~~National Bank Act and NYBL do not contain independent fraudulent transfer provisions that apply generally to transfers of assets by an insolvent institution.[583] However, it is possible that a receiver or conservator appointed under the ~~NBA~~National Bank Act or the NYBL, including the FDIC, also may be able to assert the rights of a creditor under the New York fraudulent conveyance law described in Section XII.A.2(i) above, or under fraudulent transfer statutes in effect in other jurisdictions affecting or affected by the relevant transfer.[584] In addition, the FDIC as receiver can avoid pre-insolvency transfers made with "intent to hinder, delay, or defraud" the bank, the FDIC as conservator/receiver, or other regulators.[585]

Furthermore, under Section 13(e) of the FDIA, no contract may be enforced against the FDIC, whether acting as a receiver or in its corporate capacity as liquidator of bank assets, unless it (i) is in writing, (ii) was executed by the institution and the other party "contemporaneously" with the acquisition of the related asset by the depository institution, (iii) was approved by the board of directors of the depository institution or its loan committee (as reflected in the minutes of such body), and (iv) has been, since its execution, an official record of the depository institution. Until the early

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582 *See, e.g., Davis* v. *Elmira Savings Bank*, 161 U.S. 275 (1896); *People* v. *Mechanics & Traders Savings Inst.*, 92 N.Y. 7 (1883); *Lafayette Trust Co.* v. *Beggs*, 107 N.E. 644, 647 (N.Y. 1914) (Miller, J., concurring).

583 The FDIA does contain a provision permitting the FDIC to avoid fraudulent transfers by an "institution-affiliated party" of an insolvent institution, but this provision does not authorize the avoidance of a transfer made by the institution itself. 12 U.S.C. § 1821(d)(17).

584 *See* 12 U.S.C. §§ 1821(c)(2)(B) and 1821(c)(3)(B).

585 *Id.* § 1821(d)(17).

1990's, most courts had concluded that Section 13(e) did not apply to agreements other than loans and similar transactions in which the borrower sought to avoid its obligation by reference to an unrecorded side agreement with the institution. However, in a 1992 case, the court found that Section 13(e) was applicable to a security agreement in which an insured depository institution had agreed to pledge assets to secure a deposit made by a governmental entity.[586] Because it generally is simply not possible to comply with Section 13(e) in the case of a collateral arrangement (if only because collateral is almost never acquired by a bank at the same time as it is pledged by the bank to a third party), this decision raised concern throughout the financial community with respect to collateral arrangements with insured depository institutions. However, the FDIC has adopted a policy statement[587] that protects most ordinary course collateral arrangements, and a policy statement specifically for QFCs (as defined in Section XII.D.3 below).[588] As noted in Section IV above, we have assumed that the FCM and uncleared swaps affiliate have complied with the requirements of this policy statement in connection with any customer that is an insured depository institution.

(ii) *Restrictions on Actions After the Commencement of the Proceeding*

Although the FDIA does not impose an automatic stay as the Bankruptcy Code does, as discussed in Section XII.A.2(ii) above, Section 11(d)(12) of the FDIA provides that, when the FDIC has been appointed as conservator or receiver of a failed depository institution, it may request a stay of any judicial action to which the institution is or becomes a party.[589] This stay extends for 45 days in the case of a conservatorship and for 90 days in the case of a receivership.[590] As a matter of practice, the FDIC routinely obtains such stays at the time of its appointment as either conservator or receiver.

In addition, Section 11(d)(13)(C) of the FDIA prohibits any person from exercising any right to terminate, accelerate, or declare a default under any contract to which the institution is a party, or to obtain possession of or exercise control over any property of the institution or affect any of the institution's contractual rights, without the consent of the conservator or receiver.[591] This stay lasts 45 days, in the case of a receivership, and 90 days, in the case of a conservatorship.

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586 *North Arkansas Medical Center* v. *Barrett*, 962 F.2d 780 (8th Cir. 1992).

587 *Statement of Policy Regarding Treatment of Security Interests After Appointment of the FDIC as Conservator or Receiver*, 58 Fed. Reg. 16,833, 16,834 (Mar. 31, 1993) [hereinafter Security Interests Policy Statement].

588 *FDIC Statement of Policy on Qualified Financial Contracts*, FDIC (Dec. 12, 1989), *available at* https://www.fdic.gov/regulations/laws/rules/5000-1100.html.

589 12 U.S.C. § 1821(d)(12).

590 *Id*.

591 *Id.* § 1821(e)(13)(C).

Once the 45- or 90-day period has expired, then parties may exercise rights against the insured institution unless those rights are precluded under other provisions of the FDIA (such as the anti-*ipso facto* clause provisions described below). As a result, after the stay period has ended, if a party has (taking into account the other restrictions of the FDIA) the right to foreclose in collateral, there is no stay to preclude the creditor from doing so.[592]

In addition, similar to the anti-*ipso facto* provision of Section 365(e)(1) of the Bankruptcy Code, Section 11(e)(13) of the FDIA permits the FDIC, as conservator or receiver, to enforce any contract to which an insured depository institution is a party even if the contract contains provisions providing for termination, default, acceleration or exercise of rights upon, or solely by reason of, the insolvency of the institution or the appointment of a conservator or receiver.[593] As a result, a party to a contract with a depository institution may not exercise any remedies, including any termination right, arising as a result of the depository institution's insolvency or the appointment of a conservator or receiver.

In addition, the FDIC, as receiver for an insured depository institution, may enforce the institution's contracts notwithstanding the default of a parent or affiliate company guarantor if the parent or affiliate is a covered financial company, as described in Section XII.E below.

(iii) *Ability of Receiver or Conservator to Repudiate or Assign the Contracts*

Under Section 11(e)(1) of the FDIA, the FDIC, as conservator or receiver for an insolvent institution, may repudiate any contract (whether or not an executory contract) to which the institution is a party if that contract is "burdensome" and the FDIC determines that disaffirmance or repudiation will "promote the orderly administration of the institution's affairs."[594]

If the FDIC repudiates a contract, the contract party is no longer entitled to performance under the contract.[595] Instead, it is entitled to be paid its damages in respect

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592 *See* Statement of Policy on Foreclosure Consent and Redemption Rights, 57 Fed. Reg. 29,491 (July 2, 1992); Self-Help Liquidation of Collateral by Secured Claimants in Insured Depository Institution Receiverships, 1989 FDIC Interp. Ltr. LEXIS 69 (Dec. 15, 1989) (acknowledging ability of secured parties to liquidate collateral through "self-help" measures without need for judicial action because of absence of generalized stay).

593 12 U.S.C. § 1821(e)(13).

594 *Id.* § 1821(e)(1).

595 *See* Treatment by the Federal Deposit Insurance Corporation as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection with a Securitization or Participation, 65 Fed. Reg. 49,189 (Aug. 11, 2000) (to be codified at 12 C.F.R. pt. 360) ("Repudiation of a contract relieves the FDIC from performing any unperformed obligations remaining under the contract.").

of the FDIC's action.[596] However, the damages generally are limited to "actual direct compensatory damages" measured as of the date of the appointment of the conservator or receiver, not as of the date of repudiation.[597] Although the FDIC is required to exercise its right of repudiation within a "reasonable period" after its appointment as conservator or receiver,[598] there is no fixed limit on the time within which it may exercise this power. Furthermore, if the FDIC is appointed first as conservator and then as receiver, the "reasonable period" may begin to run a second time upon its appointment in this new capacity.

The FDIC, as conservator or receiver, also may transfer any of the assets or liabilities of an insolvent depository institution in the manner best suited to achieve the FDIC's obligation to resolve the insolvency.[599] This power includes the power to assign any contract of the insolvent institution, notwithstanding any provision of the contract prohibiting such a transfer, and no such transfer, standing alone, can form the basis for declaring an event of default under the contract.[600]

As noted above, the FDIC, as receiver, has the power to establish a bridge depository institution, or "bridge bank," and transfer the deposit liabilities, certain other liabilities and assets of the failed depository institution to that bridge bank.[601] The FDIC may make such transfers without any approval. No contractual counterparty may exercise any remedies as a result of any such transfer, and any default existing prior to the transfer as a result of the insolvency of the failed depository institution, or the appointment of a conservator or receiver, ceases to exist.

3. Safe Harbors as Applied to Liquidation of ~~Cleared Customer~~ Transactions and Foreign Futures ~~Contracts~~

Section 11(e) of FDIA sets forth the powers of the FDIC, as conservator or receiver, with respect to contracts entered into before the commencement of the proceeding under the FDIA, including the provisions described in Section XII.D.2 above. However, Section 11(e) also contains provisions protecting the ability of counterparties to terminate transactions that constitute QFCs following an insolvency of a bank, to terminate or liquidate those contracts, to net and set off all of the obligations relating to those transactions, and to liquidate and apply collateral. The FDIA defines the term "qualified financial contract~~"~~" to mean "any securities contract, commodity contract, forward contract, repurchase agreement, swap agreement, and any similar

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596 *Id*. ("Repudiation also entitles the other party to the contract to a claim for damages, which are limited by statute to actual direct compensatory damages determined as of the date of the appointment of the receiver or conservator.").

597 12 U.S.C. § 1821(e)(3).

598 *Id.* § 1821(e)(2).

599 *Id.* § 1821(d)(2)(G)(i)(II).

600 *Id.* § 1821(d)(2)(G).

601 *Id.* § 1821(n).

agreement that the [FDIC] determines by regulation, resolution, or order to be a qualified financial contract . . . . . ."[602]

The terms "securities contract," "commodity contract," "forward contract," "repurchase agreement" and "swap agreement" are defined in substantially the same manner as they are defined in the Bankruptcy Code. The term "commodity contract" is defined in the same manner as in the Bankruptcy Code, except that cleared swap contractsswaps are not explicitly made subject to the same treatment as commodity contracts.

Like the safe harbors contained in the Bankruptcy Code, the FDIA safe harbors permit a counterparty to exercise contractual remedies with respect to QFCs, as described below. However, unlike the safe harbors contained in the Bankruptcy Code, the safe harbors in the FDIA apply to all QFCs as a single category. In addition, the FDIA provides that any master agreement for any contract or agreement otherwise described as a QFC, together with all supplements to such master agreement, will be treated as a single agreement and a single qualified financial contract. If a master agreement contains provisions relating to agreements or transactions that are not themselves qualified financial contracts, the master agreement will be deemed to be a qualified financial contract only with respect to those transactions that are themselves qualified financial contracts.[603] The implication of this provision is that, unlike the Bankruptcy Code, which establishes separate safe harbors, with differing limitations, for each category of transaction before permitting the exercise of cross-product rights pursuant to Section 561 of the Bankruptcy Code, the FDIA allows the exercise of the same rights with respect to all QFCs at the same time, to the extent permitted by the applicable contractual framework.

As noted above, as a general matter, the FDIA provides that the FDIC may enforce any contract despite a termination provision triggered by the appointment of a conservator or receiver. Thus, if the FDIC does not repudiate the contract, the counterparty is prohibited from exercising any termination rights it may have, to the extent that such rights arise solely as a result of the institution's insolvency or the appointment of a conservator or receiver. Furthermore, the exercise of remedies is subject to the 45- or 90-day stay on the exercise of remedies. The counterparty must continue to comply with the contract so long as the FDIC (or its assignee) does.

However, if the FDIC is appointed as *receiver* for an institution, the FDIA permits a counterparty to exercise:

> (i) any right such person has to cause the termination, liquidation, or acceleration of any qualified financial contract with an insured depository institution which arises

602 *Id.* § 1821(e)(8)(D)(i).

603 *Id.* § 1821(e)(8)(D)(vii).

upon the appointment of the Corporation as receiver for such institution at any time after such appointment;

(ii) any right under any security agreement or arrangement or other credit enhancement related to one or more qualified financial contracts described in clause (i);[604] and

(iii) any right to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more contracts and agreements described in clause (i), including any master agreement for such contracts or agreements.[605]

In a *conservatorship*, a person may exercise:

(i) any right such person has to cause the termination, liquidation, or acceleration of any qualified financial contract with a depository institution in a conservatorship based upon a default under such financial contract which is enforceable under applicable noninsolvency law;

(ii) any right under any security agreement or arrangement or other credit enhancement related to one or more qualified financial contracts described in clause (i); and

(iii) any right to offset or net out any termination values, payment amounts, or other transfer obligations arising under or in connection with such qualified financial contracts.[606]

However, the person may not exercise any termination right arising solely from, by reason of or incidental to the appointment of a conservator for the depository institution

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604 In addition, the FDIC's general counsel has opined that, given the absence of a generalized "stay" under the FDIA, a party (other than an affiliate of the depository institution) to a bona fide, arm's-length contract would be permitted to liquidate collateral held by it as security for obligations of an insured institution even after the FDIC is appointed as a receiver for that institution, provided that the right to liquidate arose as a result of a default other than an "*ipso facto*" provision in the contract. *See* Self-Help Liquidation of Collateral by Secured Claimants in Insured Depository Institution Receiverships, 1989 FDIC Interp. Ltr. LEXIS 69 (Dec. 15, 1989). Such action would be permitted only if such foreclosure can be achieved through "self-help" measures without the need for judicial action, because of the FDIA's stay on judicial proceedings. 12 U.S.C. § 1821(d)(12). The counterparty would be required to file a proof of claim in the insolvency proceedings in respect of the insolvent institution in order to preserve its right to retain the proceeds of the liquidated collateral.

605 12 U.S.C. § 1821(e)(8)(A).

606 *Id.* § 1821(e)(8)(E).

(or the insolvency or financial condition of the depository institution for which the conservator has been appointed).[607]

These rights may be exercised notwithstanding any other provision of the FDIA, any other ~~Federal~~federal law, or the law of any state, subject only to (1) the provisions of the FDIA permitting the FDIC to disregard agreements that do not satisfy the "written agreement" requirements of Section 11(d)(9) and Section 23(e) of the FDIA,[608] and (2) the power of the FDIC to transfer the QFCs to a solvent bank or bridge bank. Because all these provisions override all state laws, these provisions apply even if an insured bank is subject to the insolvency laws of a state that imposes a stay or other restrictions on the exercise of such rights.

Moreover, the FDIA overrides the provisions of the National Bank Act, and any other ~~Federal~~federal or state law, relating to the avoidance of preferential or fraudulent transfers, by prohibiting the FDIC, whether acting as such or as conservator or receiver, from avoiding any transfer of money or other property in connection with any qualified financial contract with an insured depository institution, unless the FDIC determines that the transferee had actual intent to hinder, delay, or defraud such institution, the creditors of such institution, or any conservator or receiver appointed for such institution.[609]

The FDIA does invalidate "walk-away" clauses – *i.e.*, a provision of a QFC that "suspends, conditions, or extinguishes a payment obligation of a [non-defaulting] party, in whole or in part, or does not create a payment obligation of a [non-defaulting] party that would otherwise exist," solely because such party is a non-defaulting party in connection with an insolvency of an insured depository institution that is a party to the contract or the appointment of or the exercise of rights or powers by a conservator or receiver of such depository institution, and "not as a result of a party's exercise of any right to offset, setoff, or net obligations that exist under the contract, any other contract between those parties, or applicable law."[610] As noted in Section IV above, we have assumed that no customer agreement includes a walk-away clause.

To ensure that the FDIC may exercise its right to transfer the QFCs to a solvent transferee or a bridge bank, the FDIA prohibits a party's exercise of any termination right arising solely from the appointment of a receiver for the depository institution, or the insolvency or financial condition of the depository institution, for a period extending from the appointment of the FDIC as receiver, until 5:00 p.m. (~~eastern~~Eastern time) on the business day following the date of the appointment of the

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607 *Id.* § 1821(e)(10)(B).

608 As indicated in Section IV above, we have assumed that the FCM has complied with the requirements of ~~Section~~Sections 1821(d)(9) and 1823(e) in connection with any customer that is an insured depository institution.

609 12 U.S.C. § 1821(e)(8)(C).

610 *Id.* § 1821(e)(8)(G).

receiver. If the FDIC does successfully transfer the QFCs to a new party, the person is permanently barred from exercising termination rights arising from those events.[611]

If the FDIC elects to transfer *any* QFCs between a counterparty and an insolvent institution, the FDIC is required to transfer together in one transaction *all* QFCs between the institution and such person "or any affiliate of such person." Furthermore, the FDIC must transfer with such QFCs (i) all claims (other than claims subordinated, under the terms of the applicable contract, to general obligations of the institution) of such person or any affiliate of such person against the institution under any QFC, (ii) all claims of the institution against such person or any affiliate of such person under any QFC, and (iii) "all property securing any such claim" under any QFC.[612] This requirement is intended to preserve all rights of setoff that any counterparty or its affiliates may have against the institution or any collateral held by it.[613]

Taking these provisions together, if the FDIC is appointed as *receiver* for an insured depository institution, the FDIA would permit an FCM to exercise its contractual rights to liquidate the customer transactions as a result of the appointment of a receiver, and any rights relating to the customer margin, and to offset the rights and obligations of the customer under all QFCs between the FCM and that customer, subject to a one business day delay to permit the FDIC the opportunity to exercise its right to transfer the QFC to another insured depository institution.[614] Accordingly, unless its QFCs have been transferred to a new depository institution (or the FDIC has repudiated the QFCs), the FCM will be able to liquidate all the customer transactions that it carries for the insolvent depository institution at 5:00 p.m. on the business day following the FDIC's appointment as receiver.[615] However, if the FDIC were appointed as conservator, the FCM could not exercise any liquidation rights arising as a result of that appointment, but if the FDIC or the new institution failed to comply with its obligations in any respect that would otherwise give rise to a right to liquidate the customer transactions, the FCM would be permitted to exercise its rights to liquidate the customer transactions in accordance with the customer agreement.

If the FCM does not exercise its liquidation rights (or, in the case of a conservatorship, is prohibited from exercising them), and the FDIC does not exercise its right to transfer the customer transactions, then the FDIC may exercise its right to

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611 *Id.* § 1821(e)(10)(B)(i)(II).

612 *Id.* § 1821(e)(9)(A).

613 *See* H.R. REP. NO. 54, 101st Cong., 1st Sess., *reprinted in* 1989 U.S.C.C.A.N. 86, 127-28; *Resolution Trust Corporation* v. *Cheshire Management Company, Inc.*, 18 F.3d 330, 335-36 (6th Cir. 1994).

614 There were some statutory omissions prior to the adoption of the 2005 Act that have been corrected by this statute, thus clarifying the application of these provisions.

615 The FCM can suspend its own performance under the customer agreement during the same period of time. 12 U.S.C. § 1821(e)(8)(G)(ii).

repudiate the customer transactions.[616] However, the FDIA protects the FCM in several respects. Unlike most other contractual counterparties, whose damages for repudiation are determined as of the date on which the FDIC is appointed as conservator or receiver,[617] the damages of a QFC counterparty are measured as of the date of repudiation, which permits a QFC to terminate any related hedges contemporaneously with the repudiation. Furthermore, the "compensatory damages" to which the counterparty is entitled are to be equal to "normal and reasonable" costs of cover of the QFC counterparty, or measured in accordance with "other reasonable measures of damages utilized in the industries for such contract and agreement claims."[618] As a result, the damages should be calculated in the customary manner for an "Event of Default" as defined in the standard master agreements commonly used for swap agreements. Finally, the FDIC must repudiate all the QFCs between the failed depository institution and its counterparty or any affiliate of its counterparty, or repudiate none of them. As a result, the FCM may be precluded from liquidating the customer transactions in the event that a conservator is appointed, but it would be permitted to exercise remedies if the conservator failed to perform its obligations under the customer transactions, and to obtain damages similar to the amount it would be entitled to upon liquidating the customer transactions, if the FDIC were to repudiate the customer agreement.

In addition to the protections contained in the FDIA itself, FDICIA would protect the rights of the FCM to exercise its liquidation rights in respect of the customer transactions. Like an FCM, an insured depository institution is a "financial institution" within the meaning of FDICIA,[619] and therefore any netting contract between an insured depository institution and an FCM will be entitled to the protections of FDICIA. When applied to a failed insured depository institution, however, FDICIA is subject to the limitations contained in Section 21(e) described above.

4. Safe Harbors as Applied to Cross-Affiliate Netting

The treatment of an uncleared swaps affiliate's security interest in a customer's ~~customer~~ account with an affiliated FCM under the FDIA would be similar to the treatment of such an interest under the Bankruptcy Code. The uncleared swaps affiliate's right to foreclose upon the proceeds of the customer's ~~customer~~ account, subject to the rights of the FCM under the customer agreement and applicable law, would also be subject to the limitations imposed by the FDIA but for the safe harbors established for QFCs described above.

As noted in Section IV above, we have assumed that all uncleared swaps under the uncleared swaps agreement are "swap agreements," and therefore "qualified financial contracts," within the meaning of the FDIA. Accordingly, pursuant to the same provisions described in Section XII.D.3 above, upon the uncleared swaps affiliate's valid

616 *Id.* § 1821(e)(1).

617 *Id.* § 1821(e)(3)(A)(ii).

618 *Id.* § 1821(e)(3)(C).

619 *Id.* § 4402(6).

exercise of its right to terminate the uncleared swaps under the uncleared swaps agreement in accordance with the safe harbors described in Section- XII.D.3 above, the uncleared swaps affiliate may also rely upon the provisions of ~~Sections~~ Section 21(e)(8)(A) or Section 21(e)(8)(E), as applicable, to exercise its rights under the security agreement forming a part of the uncleared swaps agreement. As noted in footnote 592 above, however, this will be true only if the security interest may be enforced through "self-help" – as should generally be the case when the security interest is perfected by means of a properly drafted control agreement to which the FCM is a party – and without the need for litigation, because of the FDIA's stay on judicial proceedings.[620] The uncleared swaps affiliate would be required to file a proof of claim in the insolvency proceedings in respect of the insolvent institution in order to preserve its right to retain the proceeds of the liquidated collateral.

5. Safe Harbors as Applied to an FCM's Cross-Affiliate Netting

Similar to the uncleared swaps affiliate's right to foreclose on a swaps agreement, the FCM's right to foreclose on and exercise a security interest in the assets held by the uncleared swaps affiliate would be limited absent the safe harbor provisions of the FDIA for QFCs. The FDIA includes safe harbors for security agreements or arrangements.

Again, we have assumed that all uncleared swaps under the uncleared swaps agreement are "swap agreements," and therefore "qualified financial contracts," within the meaning of the FDIA. Accordingly, pursuant to the same provisions described in Section- XII.D.3 above, upon the FCM's valid exercise of its right to terminate the uncleared swaps under the uncleared swaps agreement in accordance with the safe harbors of the FDIA, the FCM may rely upon the provisions of ~~Sections~~ Section 21(e)(8)(A) or Section 21(e)(8)(E), as applicable, to exercise its rights under the security agreement. Similar to the uncleared swaps affiliates rights described above in Section- XII.D.4, this will be true only if the security interest may be enforced through "self-help" and without the need for litigation, because of the FDIA's stay on judicial proceedings.[621] The FCM would be required to file a proof of claim in the insolvency proceedings in respect of the insolvent institution in order to preserve its right to retain the proceeds of the liquidated collateral.

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620 ~~*Id.* § 1821(d)(12). *See* Self-Help Liquidation of Collateral by Secured Claimants in Insured Depository Institution Receiverships, 1989 FDIC Interp. Ltr. LEXIS 69 (Dec. 15, 1989). Such action would be permitted only if such foreclosure can be achieved through "self-help" measures without the need for judicial action~~ *Id.* § 1821(d)(12). *See supra* note 604.

621 12 U.S.C. §- 1821(d)(12). *See* Self-Help Liquidation of Collateral by Secured Claimants in Insured Depository Institution Receiverships, 1989 FDIC Interp. Ltr. LEXIS 69 (Dec. 15, 1989). Such action would be permitted only if such foreclosure can be achieved through "self-help" measures without the need for judicial action.

E. Customers Subject to OLA

Title II of the Dodd-Frank Act establishes a system for liquidation of systemically important nonbank financial companies, including broker-dealers and bank holding companies. The new system is based on the FDIC resolution model for depository institutions, but that model was modified in significant respects, both to address the differences in the nature of nonbank financial companies as compared to banks, and to reassure creditors by reducing disparities between the manner in which their claims would be dealt with under the Bankruptcy Code and the manner in which those claims would be treated in a proceeding under Title II of the Dodd-Frank Act instead. Title II is often referred to as the "orderly liquidation authority" or "OLA."

1. Entities Covered by OLA

A financial company may be designated as a "covered financial company" by the Secretary of the Treasury, and thus made subject to an OLA proceeding, administered by the FDIC as receiver, upon a determination by the Treasury Secretary that the company is in default or in danger of default and that the default presents a systemic risk to U.S. financial stability.

A financial company, as defined in Title II of the Dodd-Frank Act,[622] means a company that is: incorporated or organized under any provision of ~~Federal~~federal law or the laws of any State; either (1) a bank holding company, (2) a nonbank financial company supervised by the Federal Reserve Board due to its systemic significance, (3) predominantly engaged[623] in activities that the Federal Reserve Board has determined are financial in nature under Section 4(k) of the Bank Holding Company Act of 1956, or (4) any subsidiary of any of the foregoing, other than a subsidiary that is an insured depository institution or an insurance company; and is not a Farm Credit System institution under the Farm Credit Act of 1971, a governmental entity, or a regulated entity under the Federal Housing Enterprises Financial Safety and Soundness Act of 1992.

Banks and insurance companies themselves are not subject to OLA proceedings; these entities are left to resolution by the FDIC under the FDIA, and by the states under state rehabilitation and liquidation laws, respectively.[624]

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622 *See* Dodd-Frank Act § 201(a)(11).

623 For this purpose, a company will not be deemed to be "predominantly engaged" in activities that are financial in nature if the consolidated revenues of the company and all its subsidiaries, including those from depository institutions, derived from such activities constitute less than 85 percent of the total consolidated revenues of such company and all its subsidiaries, including those from depository institutions, under regulations established by the FDIC, in consultation with the Treasury Department. Dodd-Frank Act § 201(b).

624 The FDIC is given "backup authority" to liquidate an insurance company. Dodd-Frank Act § 203(e)(3).

A Title II liquidation proceeding with respect to a financial company would begin with the making of a systemic risk determination by the Secretary of the Treasury.[625] The Treasury Secretary may make such a determination only upon the recommendation of the Federal Reserve Board, together with either (1) the FDIC, (2) the SEC, in the case of a company that is or whose largest subsidiary is a broker-dealer, or (3) the director of the Federal Insurance Office, in the case of a company that is or whose largest subsidiary is an insurance company. Any such recommendation by the Federal Reserve Board, FDIC or SEC must be approved by a supermajority of two-thirds of the members of the Federal Reserve Board, of the board of directors of the FDIC or of the SEC, as applicable. The determination by the Treasury Secretary must also be made after consultation with the President. The Treasury Secretary must report to the Congressional leadership within 24 hours after the appointment of a receiver under Title II, and make detailed follow-up reports thereafter, and the General Accountability Office is required to conduct a review of the determination.

The Treasury Secretary may determine that the FDIC should be appointed as receiver for a covered financial company if: (1) the financial company is in default or in danger of default; (2) the failure of the financial company and its resolution under the law that would otherwise apply would have serious adverse effects on financial stability in the United States; (3) no viable private sector alternative is available to prevent the default; (4) the impact on creditors, counterparties and shareholders of the financial company and other market participants of utilizing an OLA proceeding would be outweighed by the impact on financial stability in the United States; (5) the proposed course of action would mitigate the adverse effects on the financial system; (6) a federal agency has ordered the financial company to convert all of its regulatorily mandated convertible debt instruments to equity; and (7) the company satisfies the definition of financial company.

A financial company could be considered to be in default or danger of default if (1) a bankruptcy case has been, or promptly is likely to be, filed, (2) the financial company has incurred, or is likely to incur, losses that will deplete all or substantially all of its capital and there is no reasonable prospect to avoid such depletion, (3) the assets of the financial company are, or are likely to be, less than its liabilities, or (4) the financial company is unable to pay its obligations in the normal course of business.

If the financial company does not acquiesce or consent to the appointment of the FDIC as receiver, the Treasury Secretary must petition the U.S. District Court for the District of Columbia for an order authorizing such appointment. The court will be required to make its determination in a closed proceeding (with criminal penalties for disclosure) but with notice to, and an opportunity to participate by, the covered financial company. Section 202 of the Dodd-Frank Act further provides that the determination by

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625 *See generally* Dodd-Frank Act § 203 (providing the procedures for commencing a Title II liquidation proceeding).

the Treasury Secretary as to the danger of default (but not as to systemic risk) and the entity's status as a financial company must be reviewed and determined by the court on the basis of an "arbitrary and capricious" standard.[626] The Treasury Secretary's petition will be deemed to be automatically granted if not acted upon by the district court within 24 hours of receipt. An appeal, on a confidential basis, may be made by the financial company within 30 days to the U.S. Court of Appeals for the D.C. Circuit, and thereafter to the U.S. Supreme Court. Expedited consideration is provided for in both appellate courts, and the decision of the district court will not be subject to a stay during the appeals process.

2. Powers of the FDIC as a Receiver

The Dodd-Frank Act provides for the FDIC to serve as receiver of a covered financial institution; there are no conservatorship provisions or provisions corresponding to Title VII of the Bankruptcy Code. The receivership is subject to a limited term, at the end of which the liquidation of the failed company must be complete.[627]

Because any proceeding under the Dodd-Frank Act can be commenced only after all these determinations are made, it is not possible to predict in advance whether any particular financial company, or its subsidiary, would be liquidated under the Dodd-Frank Act or under the insolvency statute that would otherwise apply. If a proceeding is commenced under Title II of the Dodd-Frank Act, then the provisions of the Act will supersede those of the Bankruptcy Code, or whatever other statute would have governed the insolvency of the failed company. The liquidation proceeding will be conducted as an administrative proceeding by the FDIC, rather than as a court-supervised proceeding as under the Bankruptcy Code. The procedures to be followed by the FDIC, as well as the powers granted to it, were based largely on the provisions of the FDIA, but many of the substantive powers granted to the FDIC to override creditors' rights were based on the Bankruptcy Code.

As noted above, Title II has not yet been invoked with respect to any person. The FDIC has adopted initial regulations under Title II of the Dodd-Frank Act, and those regulations are codified at 12 C.F.R. Part 380. A number of additional regulations are specifically required under Title II, and the FDIC has indicated that it intends to consider further regulations to clarify the provisions of Title II as well. Accordingly, the conclusions with respect to the Dodd-Frank Act reached in this opinion are necessarily limited.

(i) *Avoidance of Pre-Petition Transfers*

Section 210(a)(11)(B) permits a receiver to avoid a transfer that occurred prior to the receiver's appointment if the transfer was made: (i) to or for the benefit of a

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626 Dodd-Frank Act § 202(a)(1)(A)(iii).

627 *Id.* § 202.

creditor; (ii) for or on account of an antecedent debt that was owed by the covered financial company before the transfer was made; (iii) that was made while the covered financial company was insolvent; (iv) that was made (I) 90 days or less before the date on which the FDIC was appointed receiver; or (II) more than 90 days, but less than one year before the date on which the corporation was appointed receiver, if such creditor at the time of the transfer was an insider; and (v) that enables the creditor to receive more than the creditor would receive if (I) the covered financial company had been liquidated under chapter 7 of the Bankruptcy Code; (II) the transfer had not been made; and (III) the creditor received payment of such debt to the extent provided by the provisions of chapter 7 of the Bankruptcy Code.

As is evident, this provision was based upon, and is largely similar to, the provisions of Section 547 of the Bankruptcy Code. However, there are some variations in related provisions that raise some question as to whether there was an error in the drafting of the statute that could result in a much broader range of transactions being avoidable under this statute than under Section 547.[628] The FDIC adopted regulations that resolved many of the discrepancies identified to date, and, as a result, it is anticipated that the preference provisions of the Dodd-Frank Act will be interpreted in a manner largely consistent with the express provisions of the Bankruptcy Code.

Section 210(a)(10) of the Dodd-Frank Act sets forth a provision permitting the receiver to avoid fraudulent transfers on terms very similar to those set forth in Section 548(a) of the Bankruptcy Code. The FDIC's initial regulations under Title II clarified some provisions of Section 210(a)(10) and seek to conform the interpretation of that provision to the corresponding provisions of the Bankruptcy Code.[629] The Dodd-Frank Act does not, however, contain a "strong-arm" provision like Section 544(b) of the Bankruptcy Code and, accordingly, it would appear that the FDIC, as receiver, would not have the authority to exercise any state law or other fraudulent transfer provisions not found in Section 210(a)(10) itself.

(ii) *Restrictions on Actions After the Commencement of the Proceeding*

Sections 210(a)(8) and 210(c)(11)(C) of the Dodd-Frank Act impose 90-day stays on judicial action and on exercise of creditors rights that are substantially similar to those of ~~Section~~ Sections 11(d)(12) and ~~Section~~ 11(d)(13)(C) of the FDIA described above. The FDIC has not adopted a policy statement or consent permitting creditors to exercise "self-help" rights corresponding to the positions it has taken under the FDIA. It is hoped that such a policy statement will be adopted as part of the pending rulemaking under Title II.

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628 *See, e.g.*, Letter of the American Securitization Forum, dated December 13, 2010, to Robert E. Feldman, FDIC.

629 12 C.F.R. § 380.9 (2020).

Section 210(c)(13)(C) of the Dodd-Frank Act contains restrictions on the operation of *ipso facto* clauses substantially similar to those set forth in Section 11(e)(13) of the FDIA, and described above in Section XII.D.2(ii) of this memorandum.

In addition, however, Section 210(c)(16) of the Dodd-Frank Act and the FDIC implementing rule[630] also permits the receiver for a covered financial company or a subsidiary of a covered financial company, including an insured depository institution, to enforce a contract of a subsidiary or affiliate of the covered financial company, the obligations under which are guaranteed or otherwise supported by the covered financial company, notwithstanding any contractual right to cause the termination, liquidation, or acceleration of such contracts based solely on the insolvency, financial condition, or receivership of the covered financial company, if the receiver either (i) transfers the related credit support to a bridge financial company or a third party within the statutory timeframe or (ii) provides "adequate support." For contracts of the subsidiaries and affiliates that are "linked to" (through a cross-default provision) but not otherwise guaranteed or supported by the covered financial company, the FDIC rule clarifies that no action is required of the receiver to enforce such contracts.

The definition of "adequate protection" as provided in the FDIC rule is consistent with the definition in Section 361 of the Bankruptcy Code. Specifically, adequate protection includes (1) making a cash payment or periodic cash payments to the counterparties of the contract to the extent that the failure to cause the assignment and assumption of the covered financial company's support and related assets and liabilities causes a loss to the counterparties, (2) providing to the counterparties a guaranty, issued by the FDIC as receiver for the covered financial company, of the obligations of the subsidiary or affiliate of the covered financial company under the contract, or (3) providing relief that will result in the realization by the counterparty of the indubitable equivalent of the covered financial company's support of such obligations or liabilities.[631]

(iii) *Ability of the FDIC to Repudiate or Transfer Contracts*

Section 210(a)(12) of the Dodd-Frank Act contains a provision limiting a creditor's right of setoff that is substantially similar to those set forth in Section 553 of the Bankruptcy Code and described above. However, two other powers of the FDIC, as receiver, may limit the rights of creditors to exercise setoff rights in a manner that differs from their position under the Bankruptcy Code.

First, Section 210(c) of the Dodd-Frank Act grants to the FDIC repudiation powers that are substantially similar to those provided under the FDIA. The FDIC, as receiver, will have the power to "repudiate" contracts that are not executory contracts, thereby permitting it to repudiate a much broader range of contracts than can a trustee in bankruptcy, including guarantees and other similar obligations. If the FDIC

630 Enforcement of Subsidiary and Affiliate Contracts by the FDIC as Receiver of a Covered Financial Company, 77 Fed. Reg. 63,205 (October 16, 2012) (to be codified at 12 C.F.R. pt. 380).

631 *Id*. at 63,215.

does so, then the creditor whose contract is repudiated will be entitled to a claim for "actual direct compensatory damages" arising from the repudiation, measured as of the date of the appointment of the FDIC as receiver. This damages claim would be available for setoff, subject to limitations substantially similar to those set forth in Section 553.

Of potentially more significance, subject only to limited exceptions, the FDIC, as receiver, has the right to transfer contracts to which a covered financial company or its subsidiary is a party, notwithstanding any anti-assignment provision or restriction that would be applicable under non-insolvency law. This power goes beyond the power that a trustee in bankruptcy has to assume and assign an executory contract. Section 210(a)(12)(F) of the Dodd-Frank Act provides that if the FDIC exercises this power, then it may do so free and clear of the setoff rights of any party. Accordingly, the transferred obligation would be excluded from any setoff. The FDIC has adopted a regulation[632] providing that if it does sell or transfer an asset free and clear of a party's setoff rights, the party will have a claim against the receiver in the amount of the value of such setoff established as of the date of the sale or transfer of the assets, so long as the party has a valid claim against the failed institution. Pursuant to the statute and the FDIC's regulations, the resulting claim will be paid prior to any other general liability of the failed institution, other than those entitled to a statutory priority. If the setoff amount is less than the amount of the allowed claim, the balance of the allowed claim will be paid at the otherwise applicable level of priority for the relevant category of claim.

Under Title II, as under the FDIA, the FDIC may transfer assets and liabilities of a covered financial ~~institutions~~institution to a "bridge" financial company, which may operate all or part of the business of the covered financial institution until the FDIC is able to sell or liquidate the bridge.

3. Safe Harbors as Applied to Liquidation of ~~Cleared Customer~~ Transactions and Foreign Futures ~~Contracts~~

Section 210(c)(8)(D) of the Dodd-Frank Act contains definitions of "qualified financial contract," as well as "securities contract," "commodity contract," "forward contract," "repurchase agreement," and "swap agreement" substantially similar to those contained in the FDIA.[633] Section 210 of the Dodd-Frank Act contains provisions relating to qualified financial contracts that are generally the same as those contained in the FDIA. As under the FDIA, the FDIC will have one business day to effectuate a transfer of a QFC to a bridge financial institution or other acquirer before a counterparty to such a transaction may exercise termination rights. Under the Dodd-Frank Act, the FDIA provision invalidating "walk-away" clauses applies to all covered financial companies.

632 12 C.F.R. § 380.24 (2020).

633 12 U.S.C. § 5390(c)(8)(D).

4. Safe Harbors as Applied to Cross-Affiliate Netting

The treatment of an uncleared swaps affiliate's security interest in a customer's ~~customer~~ account with an affiliated FCM under OLA would be similar to the treatment of such an interest under the FDIA. The uncleared swaps affiliate's right to foreclose upon the proceeds of the customer's ~~customer~~ account, subject to the rights of the FCM under the customer agreement and applicable law, would also be subject to the limitations imposed by the FDIA but for the safe harbors established for QFCs described above.

As noted in Section IV above, we have assumed that all uncleared swaps under the uncleared swaps agreement are "swap agreements," and therefore "qualified financial contracts," within the meaning of the OLA. The same provisions described in Section XII.E.3 above would apply to the uncleared swaps affiliate's rights as well.

5. Safe Harbors as Applied to an FCM's Cross-Affiliate Netting

The treatment of an FCM's security interest in a customer's ~~customer~~ account with an uncleared swaps affiliate under OLA would be similar to the treatment of such an interest under the FDIA. The FCM's right to foreclose upon the proceeds of the customer's ~~customer~~ account, subject to the rights of the uncleared swaps affiliate under the customer agreement and applicable law, would also be subject to the limitations imposed by the OLA but for the safe harbors established for QFCs described above.

As noted in Section IV above, we have assumed that all uncleared swaps under the uncleared swaps agreement are "swap agreements," and therefore "qualified financial contracts," within the meaning of the OLA. The same provisions described in Section XII.E.3 above would apply to the FCM's rights as well.

F. Customers Subject to HERA

1. Entities Covered by HERA

HERA amended the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 to establish a system that governs the insolvency of the Federal Home Loan Banks ("*FHLBanks*~~"),~~"), Freddie Mac, and Fannie Mae (together, "*Regulated Entities*~~").~~"). Among other things, HERA created the Federal Housing Finance Agency ("*FHFA*~~")~~")[634] to oversee the Regulated Entities' safety and soundness requirements and explicitly granted the FHFA the statutory authority to place a financially troubled regulated entity into conservatorship or receivership.

634 FHFA replaced the Office of Federal Housing Enterprise Oversight, Federal Housing Finance Board, and the Department of Housing and Urban Development as overseers of the Regulated Entities.

Prior to the passage of HERA, the law governing the resolution of the Regulated Entities was unclear and limited. Neither the Federal Home Loan Bank Act nor any regulation provided specific statutory or regulatory guidance as to how creditors and other parties would be treated in a liquidation or reorganization of an FHLBank.[635] At the same time, prior to the passage of HERA, the Safety and Soundness Act allowed regulators to place Freddie Mac or Fannie Mae into a conservatorship, but did not establish any the authority to place them in a receivership. HERA alleviated the uncertainty and limitations by establishing a comprehensive insolvency regime for the Regulated Entities that closely parallels the FDIC's approach to conservatorships and receiverships.

One notable difference between the FDIC and FHFA's resolution authority is that the FHFA is not required to resolve a failing Regulated Entity in the "least costly" manner as the FDIC is required to when resolving a failing bank. The difference stems from the lack of insured deposits to protect—FHLBanks are not federally insured depository institutions, and Fannie and Freddie do not hold deposits at all. However, we believe that this difference does not affect the application of the safe harbors described below.

2. Restrictions and Powers of the Federal Housing Finance Agency

The FHFA may appoint itself as a conservator or receiver for the Regulated Entities,[636] and the grounds on which the FHFA can be appointed are largely identical to those provided to the FDIC for banks. Once the FHFA is appointed as a conservator or receiver, it would succeed by operation of law to the rights, titles, powers, and privileges of the entity, and its officer, directors, and stockholders.[637]

In a manner substantially similar to the FDIA, HERA provides the FHFA with a wide array of core resolution powers in handling an insolvent Regulated Entity. Among other things, the FHFA may: (i) avoid fraudulent transfers made with the intent to hinder, delay, or defraud the Regulated Entity;[638] (ii) obtain 45- or 90-day stays of judicial actions; (iii) enforce most of the enterprise's contracts even if the contract contains *ipso facto* clauses providing for termination, default, acceleration or exercise of rights upon, or solely by reason of, insolvency or the appointment of a conservator or receiver;[639] (iv) repudiate contracts (with the exception of loans from the FHLBanks,

635 *See* 12 U.S.C. §- 1446.

636 *Id*. §- 4617(a)(l).

637 *Id*. §- 4617(b)(2)(A).

638 *Id*. §- 4617(b)(15).

639 *Id*. §- 4617(d)(13).

Federal Reserve Board, or Treasury) within a reasonable time;[640] and (v) transfer a Regulated Entity's assets or liabilities without any approval.[641]

When the FHFA is exercising authority as a receiver, the FHFA enjoys additional resolution powers, including the ability to transfer the assets into a life-limited regulated entity ("*LLRE*~~"),~~"), which is largely equivalent to a bridge bank under the FDIA or a bridge institution under OLA. Unlike bridge institutions under OLA, however, LLREs can obtain credit that is secured by a senior or equal lien on assets already encumbered to secure other obligations, including QFCs, provided the LLRE is unable to obtain credit otherwise on commercially reasonable terms and there is "adequate protection" of the earlier lien holders.[642]

3. Safe Harbors as Applied to Liquidation of ~~Cleared Customer~~ Transactions and Foreign Futures ~~Contracts~~

Similar to the insolvency regimes examined above, HERA also contains exceptions for the treatment of qualified financial contracts. HERA defines a "qualified financial contract" as "any securities contract, commodity contract, forward contract, repurchase agreement, swap agreement, and any similar agreement that the [FHFA] determines by regulation, resolution, or order to be a qualified financial contract for purposes of [HERA]."[643] The safe harbors for QFCs protect the counterparty's rights to terminate, liquidate, or accelerate any QFC with a Regulated Entity as well as netting rights.[644] However, a counterparty may not exercise these rights solely by reason of or incidental to the appointment of a conservator,[645] or in the case of an appointment of a receiver, until 5:00 p.m. (eastern time) on the business day following the date of the appointment or after receiving notice of transfer of all of the counterparty's QFCs with the Regulated Entity.[646] Additionally, the conservator or receiver may transfer or repudiate QFCs, which may further limit the rights of counterparties. Similar to the insolvency regime under the FDIA or OLA, a conservator or receiver must transfer or repudiate either all or none of the Regulated Entity's QFCs.[647]

4. Safe Harbors as Applied to Cross-Affiliate Netting

The treatment of an uncleared swaps affiliate's security interest in a customer's ~~customer~~ account with an affiliated FCM under HERA would be similar to

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640 *Id.* §- 4617(d)(1), (2), (15). The FHFA issued a final rule, which among other things, defines "reasonable time" to repudiate contracts as 18 months. 12 C.F.R. §- 1237.5(b) (2020).

641 12 U.S.C. §- 4617(b)(2)(G).

642 12 C.F.R. §- 1237.11(c) (2020).

643 12 U.S.C. §- 4617(d)(8)(D)(i).

644 *Id.* §- 4617(d)(8)(A), (E).

645 *Id.* §- 4617(d)(10)(B)(ii).

646 *Id.* §- 4617(d)(10)(B)(i).

647 *Id.* §- 4617(d)(9), (11).

the treatment of such an interest under the FDIA. Fannie Mae, Freddie Mac, and FHLBanks are "financial institutions" for purposes of the netting provisions of the FDICIA.[648] The uncleared swaps affiliate's right to foreclose upon the proceeds of the customer's ~~customer~~ account, subject to the rights of the FCM under the customer agreement and applicable law, would also be subject to the limitations imposed by the HERA but for the safe harbors established for QFCs described above.[649]

5. Safe Harbors as Applied to an FCM's Cross-Affiliate Netting

The treatment of an FCM's security interest in a customer's ~~customer~~ account with an uncleared swaps affiliate under HERA would be similar to the treatment of such an interest under the FDIA. The FCM's right to foreclose upon the proceeds of the customer's ~~customer~~ account, subject to the rights of the uncleared swaps affiliate under the customer agreement and applicable law, would also be subject to the limitations imposed by HERA but for the safe harbors established for QFCs described above.

6. Conservatorship of Fannie Mae and Freddie Mac

On September 7, 2008, the FHFA placed Fannie and Freddie into conservatorship, and there is no hard-line deadline on when the enterprises will exit.[650] However, we believe that the conservatorship does not have a significant impact on the analysis above.

G. Customers Subject to Specified State Insurance Insolvency Laws

1. Background and Scope

Section 109 of the U.S. Bankruptcy Code provides that neither a domestic insurance company nor a foreign insurance company may be a "debtor" under the bankruptcy code. More generally, the McCarran-Ferguson Act (15 U.S.C. §§ 1011-1015), passed by Congress in 1945, provides that state laws governing the business of insurance cannot be invalidated, preempted, impaired or superseded by any federal law

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648 Fed. Reserve Bd., Interpretive Letter (July 10, 1996) (in the case of Fannie Mae); Fed. Reserve Bd., Interpretive Letter (Jan. 13, 1997) (in the case of Freddie Mac); Fed. Reserve Bd., Interpretive Letter (July 7, 1998) (in the case of the Federal Home Loan Banks).

649 The FDICIA provides that "[n]~~othing withstanding~~otwithstanding any other provision of State or Federal law (other than .~~-~~..[section 4617 of HERA] .~~-~~..), the covered contractual payment obligations and the covered contractual payment entitlements between any 2 financial institutions shall be terminated, liquidated, accelerated, and netted in accordance with, and subject to the conditions of, the terms of any applicable netting contract (except as provided in section 561(b)(2) of title 11)." 12 U.S.C. § 4403(a).

650 In a recent interview, FHFA Director Mark Calabria hinted at the possibility that the enterprises could remain in conservatorship until 2024. *See* Pete Schroeder & Ricard Leong, *Fannie Mae, Freddie Mac Shares Down on 5-Year Timeline Overhaul*, REUTERS (July 18, 2019), *available at* https://www.reuters.com/article/us-fannie-freddie-stocks/fannie-mae-freddie-mac-shares-down-on-5-year-timeline-overhaul-idUSKCN1UD23F.

unless the federal law specifically relates to the business of insurance. Accordingly, an insolvency proceeding with respect to any insurance company doing insurance business in the United States is subject to applicable state insurance insolvency laws. The state insurance insolvency laws of the state where an insurance company is domiciled (*i.e.*, incorporated or organized) primarily, and often exclusively, govern an insurer's insolvency proceedings.[651] However, insolvency proceedings may be instituted in a state against an insurer licensed but not domiciled in such state, which would typically, but not necessarily, be ancillary to and follow the lead of insolvency proceedings conducted in the domiciliary state.

State insurance insolvency laws contain specific procedures with respect to ancillary proceedings in non-domiciliary states and for "conservation" or other proceedings against "foreign" or "alien" insurance companies that do insurance business in the state.[652] In this memorandum, we express no opinion regarding any potential effect that ancillary proceedings against an FCM's customer conducted in a non-domiciliary state may have on an FCM's liquidation, close out, netting or other rights. In addition, we express no opinion regarding the application of conservatorship or other insolvency proceedings under state insurance laws against foreign or alien insurers that are branched into or otherwise authorized to do insurance business in a state. This memorandum only addresses formal rehabilitation or liquidation proceedings conducted against insurers domiciled in Covered Insurance Jurisdictions (as defined below) under the state insurance laws of the Covered Insurance Jurisdiction where the insurer is domiciled.

Resolution proceedings against an insurance company under state insurance laws may take the form of rehabilitation, liquidation, conservatorship or seizure, and are termed collectively as "delinquency proceedings" or "receivership proceedings." Receivership proceedings may be instituted under several grounds provided for under state insurance insolvency laws, including in circumstances where the insurer is solvent (*e.g.,* where the insurer is in violation of certain laws, its capital or

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651 This is the case even where an insurance company, or the parent or an affiliate of an insurance company, has been determined to pose systemic risk under OLA. OLA provides that the liquidation or rehabilitation of an insurance company shall be conducted as provided under applicable state law (12 U.S.C. §- 5383(e)(1)), although non-insurance company affiliates of the insurance company may be subject to OLA resolution proceedings. Under OLA, if after 60 days from the date of a determination under OLA that an insurance company's insolvency under otherwise applicable insolvency law would pose a systemic risk to the U.S. financial system, the "appropriate regulatory agency has not filed the appropriate judicial action in the appropriate state court to place such company into orderly liquidation under the laws and requirements of the State," the FDIC can stand in the place of such state regulatory agency and file for orderly liquidation of the company under state law. 12 U.S.C. §- 5383(e)(3). However, even under this circumstance, the liquidation or rehabilitation of the insurance company would be conducted under applicable state insurance law and by the appropriate state insurance regulator.

652 Insurance companies domiciled in a state are termed "domestic" insurers, whereas insurers licensed and authorized to do insurance business in such state but domiciled in another U.S. state are termed "foreign" insurers, and insurers licensed and authorized to do insurance business in such state but incorporated in a non-U.S. jurisdiction are termed "alien" insurers.

surplus is deficient, further transaction of its business would be hazardous to policyholders, creditors or the public, and other specified grounds). The "receiver" in delinquency proceedings refers to the liquidator, rehabilitator or conservator, as the context requires, who is typically the primary state insurance regulator (*i.e.*, commissioner, director, superintendent, etc., of the applicable state insurance regulatory authority) or another person within the regulatory authority designated by the primary state insurance regulator. Delinquency proceedings require filings in, and some level of supervision by, the applicable state court (the "*receivership court*").

Note that under many state insurance laws, the applicable domiciliary state insurance regulator also has the authority to place a domestic insurance company under administrative supervision pursuant to supervision, correction, direct supervision or similar orders. Administrative supervision and other similar supervisory actions are not a form of receivership proceeding and do not require filings in or supervision by courts, but rather offer a mechanism to enable heightened monitoring and oversight by the domiciliary regulator while working with a financially distressed insurer to reduce or eliminate the stresses causing the need for supervision.[653] In this memorandum, we do not express any opinion regarding any potential effect that administrative supervision or similar supervisory orders of an FCM's customer under any state insurance laws may have on an FCM's liquidation, close out, netting or other rights.

Each state, U.S. territory and the District of Columbia has its own body of insurance laws and regulations. The National Association of Insurance Commissioners ("*NAIC*") is a standard-setting and regulatory support organization created and governed by the chief insurance regulators of the 50 states, the District of Columbia and five U.S. territories. The NAIC promulgates model laws and regulations pertaining to many features of insurance regulation, although such laws have no binding effect or force except to the extent enacted at the individual state or other jurisdictional level. The NAIC has adopted two model insurance insolvency acts: (1) the Insurers Rehabilitation and Liquidation Model Act (the "*Liquidation Act*"), adopted by the NAIC in 1968 (and amended multiple times thereafter), and (2) the Insurers Receivership Model Act (the "*Receivership Act*," and together with the Liquidation Act, the "*NAIC Model Acts*"), adopted by the NAIC in 2005 as a replacement of the Liquidation Act.[654] Some, but not all, states have adopted versions of, or elements from, the NAIC Model Acts, although it

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653 There have been instances historically where an insurance regulator has issued an administrative supervision order prohibiting a domestic insurer from paying certain types of future claims without the prior approval of the regulator (*e.g.,* the New York insurance regulator prohibited certain financial guaranty insurers from paying out claims without prior approval on financial guaranty policies insuring CDS and other financial instruments; the administrative supervision order in such cases did not necessarily constitute by itself a default under the relevant financial instruments or insurance policies because no insolvency, delinquency or receivership "proceeding" had occurred).

654 The NAIC also previously adopted the Uniform Insurers Liquidation Act, but this was withdrawn in 1981 due to its obsolescence and is not addressed in this memorandum. Many states' insurance insolvency statutes continue to contain elements from the Uniform Insurers Liquidation Act, particularly in regard to ancillary proceedings conducted among "reciprocal" states.

is important to note that individual states may, and often do, modify NAIC model acts and laws when enacting them, and other state laws may supersede or otherwise interact with NAIC models and thereby alter their effect.

The NAIC Model Acts and all state insurance insolvency laws (whether or not such laws are derived from the NAIC Model Acts) either provide that the initiation of delinquency proceedings operates as an automatic stay applicable to all persons other than the receiver or authorize the receiver upon application to the receivership court to issue an injunction that has a similar effect as an automatic stay. However, as discussed below, certain provisions of the NAIC Model Acts relate to QFCs, which provisions have been enacted in several but not all U.S. jurisdictions and offer significantly greater protections to an FCM in the event of delinquency proceedings against a customer that is a U.S. insurance company than do the insurance insolvency regimes of those states that have not adopted the QFC provisions of the NAIC Model Acts. As a general matter, the QFC provisions of the NAIC Model Acts offer protections similar to those afforded by the FDIA to QFCs with insured depository institutions.

Note, however, that the NAIC issued in 2013 a guideline (the "*Guideline*~~")~~") that encourages states to consider amending their insurance insolvency laws to include a 24-hour stay similar to that in the FDIA.[655] According to the NAIC, the Guideline is not an amendment to the NAIC Model Acts but "is intended as a Guideline for use by those states seeking to require a stay with respect to the termination of a netting agreement or QFC of an insurer in insolvency."[656] The Guideline provides that a person who is a party to a netting agreement or QFC with an insurer that is the subject of a delinquency proceeding may not exercise any right that the person has to terminate, liquidate, accelerate or close out the obligations with respect to the contract by reason of the insolvency, financial condition or default of the insurer, or by the commencement of a formal delinquency proceeding, (1) until 5:00 p.m. (Eastern Time) on the business day

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655 *Guideline for Stay on Termination of Netting Agreements and Qualified Financial Contracts*, NAIC (2019), *available at* https://www.naic.org/store/free/GDL-1556.pdf.

656 According to the Guideline, states that consider the enactment of a stay should take into account the relevant federal rules: "In 2017, the [Federal Reserve], the [FDIC] and the [OCC] each adopted final rules and accompanying interpretive guidance (Final Rules) setting forth limitations to be placed on parties to certain financial contracts exercising insolvency-~~-~~related default rights against their counterparties that have been designated as a global systemically important banking organization (GSIB). The Final Rules include the definition of master netting agreement that allows netting even though termination of the transaction in the event of an insolvency may be subject to a 'stay' under several defined resolution regimes including Title II of Dodd Frank, the FDIA, as well as comparable foreign resolution regimes. Notwithstanding NAIC's request for inclusion, stays under the state insurance receivership regime (State Receivership Stays) were not included as an exemption within the definition. Therefore, unless the Final Rules are amended to recognize State Receivership Stays, if a state implements a stay as contemplated by the Guideline, insurers would find themselves disadvantaged, potentially resulting in additional costs and~~/~~/or collateral requirements given the regulatory treatment for contracts that do not meet requirements for QFCs. Therefore, if a state is considering implementation of this Guideline, consideration should be given to whether the rules of the Federal Reserve, FDIC and OCC have been amended to recognize State Receivership Stays. For example, a state could adopt a stay that would be effective if and when the Final Rules recognize State Receivership Stays."

following the date of appointment of a receiver, or (2) after the person has received notice that the contract has been transferred pursuant to the QFC transfer provisions of the insurance insolvency laws. To our knowledge, as of the date of this Memorandum, no Covered Insurance Jurisdiction has adopted the Guideline, and this Memorandum assumes that none of the Covered Insurance Jurisdictions has adopted the Guideline.

This Section XII.G first analyzes the relevant provisions of the Liquidation Act and the Receivership Act and how they would affect an FCM's rights in the case of a domestic insurer's delinquency proceeding conducted under such acts. It then analyzes relevant provisions of the New York Insurance Law, which includes QFC provisions modeled after the Receivership Act. Finally, it provides a chart covering each of the other 49 states, the District of Columbia and Puerto Rico, which chart indicates with respect to each such jurisdiction: (1) whether its insurance insolvency laws contain QFC provisions; and, for those states that do contain QFC provisions, (2) to what extent the QFC-related insurance insolvency provisions are modeled after the Liquidation Act or the Receivership Act (or a combination thereof), and (3) any material modifications in such state insurance insolvency laws from the QFC-related provisions of the applicable NAIC Model Act.

This Section XII.G and the conclusions expressed within it are limited to the application of the New York Insurance Law and those jurisdictions whose insurance insolvency laws contain QFC provisions (the "*Covered Insurance Jurisdictions*~~").~~"). [657] We do not practice law in any Covered Insurance Jurisdiction other than New York (such other jurisdictions, "*Other Covered Insurance Jurisdictions*~~"),~~"), and we have not consulted attorneys practicing in any Other Covered Insurance Jurisdiction in preparing this memorandum. Our analysis of the laws of the Other Covered Insurance Jurisdictions is based entirely on a review of such jurisdictions' enactments of the NAIC Model Acts related to QFCs. We have assumed that each Other Covered Insurance Jurisdiction's adoption of the NAIC Model Acts provisions would be interpreted in accordance with the plain meaning of those provisions and have further assumed that any deviations in a state from the NAIC Model Act QFC provisions would be interpreted by the courts in the relevant Other Covered Insurance Jurisdiction as a New York court would interpret such modifications if adopted in the New York statute. We have not reviewed any legislative history or case law in any Other Covered Insurance Jurisdiction.

[657] The Covered Insurance Jurisdictions are: New York; Arizona; Colorado; Connecticut; Delaware; Illinois; Indiana; Iowa; Kansas; Maine; Maryland; Massachusetts; Michigan; Minnesota; Missouri; Nebraska; New Jersey; Ohio; Tennessee; Texas; Utah; Virginia; and Wisconsin.

2. Liquidation Act

(i) *Automatic Stay and Powers of the Receiver*

An application or petition for a seizure order or formal delinquency proceeding[658] under the Liquidation Act "operates as a matter of law as an automatic stay applicable to all persons and entities, other than the receiver, which shall be permanent and survive the entry of an order of conservation, rehabilitation or liquidation, and which shall prohibit," among other things: "(a) the transaction of other business; (b) the transfer[659] of property; (d) waste of the insurer's assets; … (g) the obtaining of preferences, judgments, attachments, garnishments or liens against the insurer, its assets or its policyholders; … or (k) any other threatened or contemplated action that might lessen the value of the insurer's assets or prejudice the rights of policyholders, creditors or shareholders, or the administration of any proceeding under [the Liquidation Act]."[660] In addition, the receiver may apply for, and the receivership court may grant, injunctions and other orders barring the institution or prosecution of claims and other actions. As a general matter, unless a specific exemption is set forth in the Liquidation Act, the stay applies to all parties unless and until either the delinquency proceeding is completed or the receivership court modifies or grants relief from the stay with respect to a particular party. The receiver may avoid any action taken in violation of the automatic stay.

Under a rehabilitation proceeding, the rehabilitator is authorized to take such action as the rehabilitator deems necessary or appropriate to reform and revitalize the insurer, and is granted with full power to direct and manage, and to deal with the property and business of, the insurer. Under a liquidation proceeding, the liquidator is also vested by operation of law with title to all of the property, contracts and rights of action of the insurer. Rehabilitators and liquidators are granted with broad powers, including to sell, transfer or otherwise dispose of any property of the insurer; to affirm or disaffirm any contract to which the insurer is a party; to avoid fraudulent transfers[661] and

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658 "Delinquency proceeding" is defined to mean "any proceeding instituted against an insurer for the purpose of liquidating, rehabilitating or conserving such insurer, and any summary proceeding under Section 10 [*i.e.,* seizure orders]." INSURERS REHAB. AND LIQUIDATION MODEL ACT §- 3(F) [hereinafter LIQUIDATION ACT]. "Formal delinquency proceeding" means "any liquidation or rehabilitation proceeding." *Id*.

659 The Liquidation Act defines "transfer" to include "the sale and every other and different mode, direct or indirect, of disposing of or of parting with property or with an interest therein, or with the possession thereof or of fixing a lien upon property or upon an interest therein, absolutely or conditionally, voluntarily, by or without judicial proceedings." LIQUIDATION ACT §- 3(W). The Receivership Act employs a substantially similar definition. INSURERS RECEIVERSHIP MODEL ACT §- 104(FF) [hereinafter RECEIVERSHIP ACT].

660 LIQUIDATION ACT §- 5(A).

661 "Every transfer made or suffered and every obligation incurred by an insurer within one year prior to the filing of a successful petition for rehabilitation or liquidation under this Act is fraudulent as to then existing and future creditors if made or incurred without fair consideration, or with actual intent to hinder, delay or defraud either existing or future creditors." *Id.* §- 29(A). "Fair consideration" is given for property or obligation under the Liquidation Act "when in exchange for

voidable preferences[662] and liens; and to exercise and enforce all the rights, remedies and powers of any creditor, shareholder or policyholder, including any power to avoid any transfer or lien that may be given under general law.[663]

Under the Liquidation Act, conservation proceedings are limited to delinquency proceedings instituted against foreign or alien insurers, and are therefore not addressed in this memorandum. Seizure orders against a domestic insurer may be issued *ex parte* and without notice or hearing by the receivership court upon a filing by the state insurance regulatory authority. The receivership court is required to specify the duration of the seizure order, and must vacate the seizure order if the regulator does not commence a formal delinquency proceeding (*i.e.*, rehabilitation or liquidation) after a reasonable opportunity to do so.

In light of the above automatic stay and avoidance powers, absent the special treatment of QFCs as discussed below, the commencement of a formal delinquency proceeding against a customer under the Liquidation Act would give the receiver the power to invalidate or reverse certain transactions that occurred between the FCM and the defaulting insurer prior to the commencement of the proceeding, and limit the FCM's ability to exercise its contractual rights against the defaulting customer. In the absence of the QFC safe harbors, these provisions would also permit a receiver to reverse pre-petition transfers of margin or other amounts by the customer to the FCM.

The Liquidation Act further provides that the entry of an order of rehabilitation "shall not constitute an anticipatory breach of any contracts of the insurer nor shall it be grounds for retroactive revocation or retroactive cancellation of any contracts of the insurer, unless the revocation or cancellation is done by the rehabilitator."

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the property or obligation, as a fair equivalent therefore, and in good faith, property is conveyed or services are rendered or an obligation is incurred or an antecedent debt is satisfied," or "when the property or obligation is received in good faith to secure a present advance or antecedent debt in an amount not disproportionately small as compared to the value of the property or obligation obtained." *Id.* § 3(I).

662 Under Section 32 of the Liquidation Act, a "preference" is a transfer of any of the property of an insurer to or for the benefit of a creditor, for or on account of an antecedent debt, made or suffered by the insurer within one year before the filing of a successful petition for liquidation, the effect of which transfer may be to enable the creditor to obtain a greater percentage of this debt than another creditor of the same class would receive. *Id.* § 32(A)(1). If a liquidation order is entered while the insurer is already subject to a rehabilitation order, then the transfers are deemed preferences if made or suffered within the shorter of (x) one year before the filing of the successful petition for rehabilitation, or (y) within two years before the filing of the successful petition for liquidation. *Id*. The liquidator may avoid any preference if (i) the insurer was insolvent at the time of the transfer; (ii) the transfer was made within four months before the filing of the petition; (iii) the creditor had, at the time when the transfer was made, reasonable cause to believe that the insurer was insolvent or was about to become insolvent; or (iv) the creditor was an officer, employee of shareholder holding, directly or indirectly, more than 5% of the insurer's equity securities. *Id.* § 32(A)(2).

663 This last power is similar to the "strong-arm" powers under the Bankruptcy Code, discussed in Section XII.A.2(i) above.

Accordingly, absent the special treatment of QFCs discussed below, even if a contract gives a party the right to terminate a contract upon the insurer's delinquency proceeding, that right cannot be exercised. As is the case with respect to the receiver's avoidance powers, these post-petition limitations would significantly limit an FCM's rights following its customer's default, but for the adoption of the QFC safe harbors described below.

(ii) *Qualified Financial Contract Safe Harbors*

Section 46 of the Liquidation Act provides broad exceptions to the automatic stay and the receiver's avoidance powers.[664] Section 46(A) of the Liquidation Act provides:

> Notwithstanding any other provision of this Act, including any other provision of this Act permitting the modification of contracts, or other law of a state, no person shall be stayed or prohibited from exercising:
>
> (1) A contractual right[665] to terminate, liquidate or close out any netting agreement or qualified financial contract with an insurer because of: (a) the insolvency, financial condition or default of the insurer at any time, provided that the right is enforceable under applicable law other than this Act; or (b) the commencement of a formal delinquency proceeding under this Act.
>
> (2) Any right under a pledge, security, collateral or guarantee agreement or any other similar security arrangement or credit support document relating to a netting agreement or qualified financial contract.
>
> (3) Subject to the Liquidation Act's set off provision (discussed in Section XII.G.2(ii)(3)) below~~)~~, any right to set off or net out any termination value, payment amount, or other transfer obligation arising under or in connection with a netting agreement or qualified financial contract where the counterparty or its guarantor is organized under

664 Even without the Liquidation Act's QFC provisions, the Liquidation Act would permit FCMs to set off amounts against an insurer in delinquency proceedings, subject to certain exceptions, as discussed in Section XII.G.2.(ii)(3) below.

665 "Contractual right" is defined to include "any right, whether or not evidenced in writing, arising under statutory or common law, a rule or bylaw of a national securities exchange, national securities clearing organization or securities clearing agency, a rule or bylaw, or a resolution of the governing body, of a contract market or its clearing organization, or under law merchant." LIQUIDATION ACT § 46(G).

the laws of the United States or a state or foreign jurisdiction approved by the Securities Valuation Office (SVO) of the NAIC as eligible for netting.

The Liquidation Act defines "qualified financial contract" as a "commodity contract, forward contract, repurchase agreement, securities contract, swap agreement and any similar agreement that the commissioner determines by regulation, resolution or order to be a qualified financial contract for the purposes of this Act."[666] The Liquidation Act provides the following additional definitions:

- "Commodity contract" is defined to mean: "(a) a contract for the purchase or sale of a commodity for future delivery on, or subject to the rules of, a board of trade designated as a contract market by the Commodity Futures Trading Commission under the Commodity Exchange Act (7 U.S.C. § 1, *et seq*.) or board of trade outside the United States; (b) an agreement that is subject to regulation under Section 19 of the Commodity Exchange Act (7 U.S.C. § 1, *et seq*.) and that is commonly known to the commodities trade as a margin account, margin contract, leverage account or leverage contract; or (c) an agreement or transaction that is subject to regulation under Section 4c(b) of the Commodity Exchange Act (7 U.S.C. § 1, *et seq*.) and that is commonly known to the commodities trade as a commodity option."[667]

- "Forward contract" is defined to mean a "contract (other than a commodity contract) for the purchase, sale or transfer of a commodity, as defined in Section 1 of the Commodity Exchange Act (7 U.S.C. § 1, *et seq*.), or any similar good, article, service, right or interest that is presently or in the future becomes the subject of dealing in the forward contract trade, or product or byproduct thereof, with a maturity date more than two (2) days after the date the contract is entered into, including, but not limited to, a repurchase transaction, reverse repurchase transaction, consignment, lease, swap, hedge transaction, deposit, loan, option, allocated transaction, unallocated transaction or a combination of these or option on any of them."[668]

- "Repurchase agreement" (which also applies to a reverse repurchase agreement) is defined to mean "an agreement, including related terms, that provides for the transfer of certificates of deposit, eligible bankers' acceptances, or securities that are direct obligations of, or that are fully guaranteed as to principal and

666 *Id.* § 3(Q).

667 *Id.* § 3(Q)(1).

668 *Id.* § 3(Q)(2).

interest by, the United States or an agency of the United States against the transfer of funds by the transferee of the certificates of deposit, eligible bankers' acceptances or securities with a simultaneous agreement by the transferee to transfer to the transferor certificates of deposit, eligible bankers' acceptances or securities as described above, at a date certain not later than one year after the transfers or on demand, against the transfer of funds. For the purposes of this definition, the items that may be subject to an agreement include mortgage-related securities, a mortgage loan, and an interest in a mortgage loan, and shall not include any participation in a commercial mortgage loan, unless the commissioner determines by regulation, resolution or order to include the participation within the meaning of the term."[669]

- "Securities contract" is defined to mean "a contract for the purchase, sale or loan of a security, including an option for the repurchase or sale of a security, certificate of deposit, or group or index of securities (including an interest therein or based on the value thereof), or an option entered into on a national securities exchange relating to foreign currencies, or the guarantee of a settlement of cash or securities by or to a securities clearing agency. For the purposes of this definition, the term ~~"security"~~'security' includes a mortgage loan, mortgage-related securities, and an interest in any mortgage loan or mortgage-related security."[670]

- "Swap agreement" is defined to mean "an agreement, including the terms and conditions incorporated by reference in an agreement, that is a rate swap agreement, basis swap, commodity swap, forward rate agreement, interest rate future, interest rate option, forward foreign exchange agreement, spot foreign exchange agreement, rate cap agreement, rate floor agreement, rate collar agreement, currency swap agreement, cross-currency rate swap agreement, currency future, or currency option or any other similar agreement, and includes any combination of agreements and an option to enter into an agreement."[671]

A drafting note to the Liquidation Act states that the QFC definitions are "intended to be consistent with definitions applicable under federal law in instances of insolvency of other types of financial institutions."

669 *Id.* §-3(Q)(3).

670 *Id.* §-3(Q)(4).

671 *Id.* §-3(Q)(5).

"Netting agreement" is defined under the Liquidation Act to mean: "a contract or agreement (including terms and conditions incorporated by reference therein), including a master agreement (which master agreement, together with all schedules, confirmations, definitions and addenda thereto and transactions under any thereof, shall be treated as one netting agreement), that documents one or more transactions between the parties to the agreement for or involving one or more qualified financial contracts and that provides for the netting or liquidation of qualified financial contracts or present or future payment obligations or payment entitlements thereunder (including liquidation or close-out values relating to such obligations or entitlements) among the parties to the netting agreement."[672]

The above QFC and netting agreement definitions encompass all the types of contracts that constitute "~~cleared customer~~ transactions" for purposes of this memorandum. Accordingly, the FCM may exercise its rights under the customer agreement, the CEA and related CFTC regulations, and applicable DCO or foreign clearing organization rules, to cause the liquidation, termination or acceleration of these contracts, to retain any margin or settlement payments received under these contracts, to exercise any contractual right under any security agreement or arrangement, or other credit enhancement, forming a part of or related to any such contracts, and (subject to the offset qualifications discussed in Section XII.G.2(ii)(3) below) to offset or net out any termination value, payment amount or other transfer obligations arising under or in connection with one or more of such transactions, notwithstanding the restrictions that otherwise would apply under the Liquidation Act. If an FCM has established portfolio margining arrangements as described in Section VIII above, some of the customer transactions may not constitute "commodity contracts" or "forward contracts" within the definitions set forth above, but should instead constitute "securities contracts" as defined above, and thus would protect (subject to the offset qualifications discussed in Section XII.G.2(ii)(3) below) the exercise of contractual rights to offset or net out any termination value, payment amount or other transfer obligations and rights under any security agreement or arrangement, or other credit enhancement, and prevent the receiver from avoiding margin payments and settlement payments made by or to an FCM in connection with a securities contract.

(1) Separate Accounts

The Liquidation Act makes clear that the QFC safe harbor provisions apply to an insurer's general account and its separate accounts. Section 46(I) of the Liquidation Act provides that "all rights of counterparties under this Act shall apply to netting agreements and qualified financial contracts entered into on behalf of the general account or separate accounts if the assets of each separate account are available only to counterparties to netting agreements and qualified financial contracts entered into on behalf of that separate account." There is some ambiguity in the language of this provision as to whether the QFC provisions would be available solely for separate accounts that only hold QFCs and not available to separate accounts that hold both QFCs

672 *Id.* § 3(O).

and other contracts (*e.g.*, insurance contracts, securities or other financial instruments that are not QFCs). We believe the rationale for the language, and the better interpretation of the provision, is that the QFC safe harbor with respect to a particular separate account is only available for, and limited to, QFCs that were entered into on behalf of that separate account, but that such separate account may hold assets other than QFCs.

~~Firstly~~First, separate accounts may hold a variety of assets, including both QFCs and securities or other instruments that are not QFCs; reading this provision to apply to separate accounts that only contain QFCs would not make practical sense and would exclude most if not all separate accounts. Separate accounts are legally segregated for the benefit of the separate account policy- or contract-holder, such that in a delinquency proceeding assets in a separate account are not chargeable with liabilities arising out of any other business of the insurer (including assets in the insurer's general account). Since assets in a separate account are segregated from the insurer's general account and effectively the property of the policy- or contract-holder (*i.e.*, in effect, the FCM's customer is the separate account and not the insurer), an FCM's rights with respect to QFCs entered into on behalf of a separate account should be limited to QFCs and netting agreements entered into with such separate account, such that QFCs and netting agreements entered into on behalf of the insurer's general account or other separate accounts of the insurer should not be able to be netted against or combined with QFCs and netting agreements specific to the separate account.

(2) Walk-Away Clauses

The Liquidation Act provides that, upon termination of a netting agreement, the net or settlement amount, if any, owed by a non-defaulting party to an insurer against which the receivership petition has been filed must be transferred to the insurer, even if the insurer is the defaulting party, notwithstanding any provision in the netting agreement that may provide that the non-defaulting party is not required to pay any net or settlement amount due to the defaulting party upon termination.[673] In other words, any limited two-way payment provision or walk-away provision in a netting agreement with an insurer that has defaulted will be dis-applied and deemed to be a full two-way payment provision as against the defaulting insurer. The Liquidation Act, similar to all insurance insolvency statutes, is intended to maximize the assets of the delinquent insurer that are available to policyholders, such that any contractual clause not permitting the insurer to collect or offset amounts otherwise owed to it on account of a default triggered solely by its delinquency proceeding will be dis-applied. In this memorandum, we assume that none of the FCM's netting agreements contain walk-away or limited two-way payment provisions.

(3) Set Off

Under Section 46(A)(3) of the Liquidation Act, as quoted above, any right to set off or net out any termination value, payment amount~~,~~ or other transfer obligation

673 *Id.* § 46(B).

arising under or in connection with a netting agreement or QFC is (1) subject to the Liquidation Act's setoff provisions (Section 34 of the Liquidation Act) and (2) only available where the insurer's "counterparty" or its guarantor "is organized under the laws of the United States or a state or foreign jurisdiction approved by the Securities Valuation Office (SVO) of the NAIC as eligible for netting."

Section 34 of the Liquidation Act provides that, except for the specified exceptions discussed below, "mutual debts or mutual credits, whether arising out of one or more contracts between the insurer and another person in connection with any action or proceeding under this Act, shall be set off and the balance only shall be allowed or paid." Section 34(B) of the Liquidation Act states, in pertinent part, that no setoff shall be allowed in favor of any person where: the obligation of the insurer to the person would not at the date of the filing of a petition for liquidation entitle the person to share as a claimant in the assets of the insurer; or the obligation of the insurer to the person was purchased by or transferred to the person with a view to its being used as a setoff (the other exceptions under Section 34(B) relate to affiliates, reinsurance counterparties or assessable members of an insurer). With respect to the first prohibition, we have assumed that the filing of a petition for liquidation would result in a default under the relevant customer agreement and therefore entitle the FCM to share as a claimant in the assets of the insurer, notwithstanding that the amount (if any) owing to the FCM may not be determinable at such time. Section 40(C) of the Liquidation Act permits the filing of contingent, unliquidated or immature claims and for such claims to share in the distribution of assets, subject to certain conditions and rules relating to valuation. Moreover, Section 46(F) of the Liquidation Act allows any claim with respect to QFCs and netting agreements that arises from a receiver's disaffirmance or repudiation of a QFC or netting agreement to be proven "as if the claim has arisen before the date of the filing of the petition for liquidation or, if a rehabilitation proceeding is converted to a liquidation proceeding, as if the claim had arisen before the date of the filing of the petition for rehabilitation." Although this Section 46(F) language only relates on its face to situations where the receiver has disaffirmed or repudiated a QFC or netting agreement, we believe this provision would also be read to apply to the offset of claims related to QFCs or netting agreements that were terminated by the FCM on the basis of the filing of a liquidation proceeding, provided the FCM files a claim (which may be contingent) within the time period required. We have assumed in this memorandum that none of the setoff prohibitions under Section 34(B) of the Liquidation Act would be applicable.

With respect to limiting offset rights to counterparties or guarantors organized under the laws of the United States or a state or foreign jurisdiction approved by the Securities Valuation Office ("*SVO*~~")~~") of the NAIC as eligible for netting, it is possible that, in addition to the FCM in privity with the insurer and that carries the customer's account, an intermediate FCM, clearing member or clearing entity could be viewed as a "counterparty" under this provision due to such entities' roles in the U.S. FCM clearing model. However, we believe the plain language of the provision is to be construed as referring to the person in contractual privity with the insurer (or such counterparty's guarantor under the relevant contract), and therefore should be limited to

the FCM that is in direct privity with the insurer (or its guarantor, if applicable), notwithstanding that the FCM may have additional contractual arrangements with intermediate FCMs, clearing members or clearing entities not in direct privity with the insurer. Accordingly, in the event that the FCM carrying the customer's account is not organized under the laws of the United States or a state or foreign jurisdiction approved by the SVO as eligible for netting, the stay under the Liquidation Act may limit the FCM's ability to exercise any netting rights.[674] However, an FCM may achieve a result similar to netting and setoff through the grant and perfection of a security interest in, and the exercise of remedies against, the customer's account and the securities and assets recorded therein. Under the assumption that the customer has granted to the FCM such security interest, that the security interest has attached and that the FCM's rights in the collateral are superior to those of other creditors under applicable law, an FCM would be able to exercise its netting rights in the event of delinquency proceedings in respect of an insurer under the Liquidation Act by exercising its rights as a secured party in respect of the FCM's payment rights, irrespective of the jurisdiction of organization of the FCM.

(4) Affiliates of the Insurer

Section 46(H) of the Liquidation Act provides that the QFC provisions "shall not apply to persons who are affiliates of the insurer that is the subject of the [delinquency] proceeding." Although this provision does not affect an FCM's termination, liquidation, close out and netting rights vis-à-vis a customer that is an insurance company subject to the Liquidation Act, the provision could have practical implications for an FCM. For example, where an insurer and a non-insurer affiliate of the insurer enter into inter-affiliate QFCs and netting agreements that mirror or are associated with QFCs and netting agreements entered into with an FCM, and the FCM carries the customer account of an insurer subject to delinquency proceedings, or of its non-insurer affiliate, the inability of the insurer and its affiliate to terminate, close out and net the inter-affiliate QFCs on account of this provision could impact the availability of proceeds with respect to the FCM. This does not affect the conclusions of this memorandum with respect to an FCM's direct legal rights against a customer that is an insurance company in delinquency proceedings under the Liquidation Act.

(5) Transfers and Repudiation

In general and subject to the qualifications expressed in this memorandum, an FCM would be able to terminate and close out transactions with respect to a delinquent insurer under the Liquidation Act immediately following the commencement of delinquency proceedings. Although this should eliminate the ability of the receiver to

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674 The NAIC has stated that netting is permitted with respect to any counterparties domiciled in the United States, such that the SVO limitation relates only to foreign counterparties. The foreign jurisdictions currently approved by the SVO as eligible for netting are: Australia, Belgium, Canada, the Cayman Islands, England, France, Germany, Ireland, Japan, Scotland, Singapore and Switzerland. *See* List of Foreign (non-U.S.) Jurisdictions Eligible for Netting for Purposes of Determining Exposures to Counterparties for Schedule DB, Part D, Section 1, *available at* https://www.naic.org/documents/svo_eligible_non_us_jurisdictions_sched_db_part_b.pdf.

transfer the insurer's netting agreements and QFCs to a third party, if the FCM were unable to or did not immediately terminate QFCs and netting agreements of the insurer, the receiver would be authorized to transfer such contracts, or to affirm, disaffirm or repudiate them.

Section 46(C) of the Liquidation Act offers protection to FCMs by prohibiting the receiver from assigning some but not all of the netting agreements and QFCs, thus requiring an "all or none" approach. Specifically, the Liquidation Act provides that:

> In making any transfer of a netting agreement or qualified financial contract of an insurer subject to a proceeding under this Act, the receiver shall either: (1) transfer to one party (other than an insurer subject to a proceeding under this Act) all netting agreements and qualified financial contracts between a counterparty or any affiliate of the counterparty and the insurer that is the subject of the proceeding, including: (a) all rights and obligations of each party under each such netting agreement and qualified financial contract; and (b) all property, including any guarantees or credit support documents, securing any claims of each party under each such netting agreement and qualified financial contract; or (2) transfer none of the netting agreements, qualified financial contracts, rights, obligations or property referred to in Subparagraph (1) (with respect to the counterparty and any affiliate of the counterparty).

The Liquidation Act further provides that if a receiver makes a transfer of one or more netting agreements or QFCs, then the receiver will use its best efforts to notify any person who is a party thereto of the transfer by 12:00 noon on the business day following the transfer.

The Liquidation Act also provides that in exercising any powers to disaffirm or repudiate a netting agreement or QFC, the receiver must take action with respect to each netting agreement or QFC and all transactions entered into in connection therewith (*i.e.*, as with transfers to third parties, an "all or none" approach is required). Any claim arising from the receiver's disaffirmance or repudiation of a netting agreement or QFC that has not been previously affirmed in the liquidation or immediately preceding rehabilitation proceeding will be determined as if the claim had arisen before the date of the filing of the petition for liquidation (or, if a rehabilitation proceeding is converted to a liquidation proceeding, as if the claim had arisen before the date of the filing of the petition for rehabilitation). The amount of the claim will be the "actual direct compensatory damages" determined as of the date of the disaffirmance or repudiation of the netting agreement or QFC. Actual direct compensatory damages under the Liquidation Act do not include punitive or exemplary damages, damages for lost profit or

lost opportunity or damages for pain and suffering, but do include "normal and reasonable costs of cover or other reasonable measures of damages utilized in the derivatives market for the contract and agreement claims."[675] As a result, the damages should be calculated in the customary manner for an "Event of Default" as defined in the standard master agreements commonly used for swap agreements. According to a drafting note of the Liquidation Act, the intended effect of these provisions is that, except where the receiver has expressly affirmed a netting agreement or QFC, the claim of a counterparty against the estate of an insolvent insurer (after completion of the netting and setoff processes) will have no greater priority than the claim of a general creditor.

As noted above, the Liquidation Act provides that, "[n]otwithstanding any other provision of this Act, … no person shall be stayed or prohibited from exercising a contractual right to terminate, liquidate or close out any netting agreement or qualified financial contract with an insurer because of: (a) the insolvency, financial condition or default of the insurer at any time … or (b) the commencement of a formal delinquency proceeding under this Act." In the event the FCM were unable to or did not immediately terminate its obligations with respect to QFCs of an insurer following the commencement of delinquency proceedings, and the receiver affirmed such QFCs, it is unclear whether the FCM would still have the ability to terminate such QFCs in light of the broad language of the QFC exception quoted above, or whether the receiver's affirmance would foreclose the ability of the FCM to thereafter terminate such contracts. The language of the Liquidation Act does not address this issue, and we are not aware of any case or guidance addressing such a scenario.

If for some reason the FCM fails to terminate its obligations with respect to the insurer's QFCs and netting agreements and the receiver affirms such contracts (and they are not successfully terminated by the FCM thereafter), or transfers them to a third party, so long as the receiver or the third party continues to perform in accordance with the terms of the transactions, the FCM could not thereafter terminate the transactions solely as a result of the insurer's delinquency proceeding. However, if the receiver or the third party fails to comply with its obligations in any respect that would otherwise give rise to a right to terminate, the FCM would be permitted to exercise its rights to terminate the transactions in accordance with the applicable agreement.

(6) Fraudulent Transfers and Preferences

The Liquidation Act provides that a receiver may not avoid a transfer of money or other property arising under or in connection with a netting agreement or QFC that is made before the commencement of a formal delinquency proceeding under the Liquidation Act, but that a transfer may be avoided if the transfer was made with "actual

675 LIQUIDATION ACT §- 46(F). Note that the Receivership Act, which has substantially the same provision, additionally provides (as underlined below) "other reasonable measures of damages utilized in the derivatives, *securities or other* market for the contract and agreement claims." RECEIVERSHIP ACT §- 711(F)(2) (emphasis added). The Receivership Act therefore expands the bases for assessing reasonable measures of damages.

intent to hinder, delay or defraud the insurer, a receiver or existing or future creditors." This memorandum assumes no transfers are made with actual intent to hinder, delay or defraud the insurer, a receiver or existing or future creditors.

(7) Safe Harbors as Applied to Cross-Product Liquidation

If the customer agreement between an FCM and its customer grants to the FCM, upon a default by the customer, cross-product liquidation rights, across the futures and cleared swap ~~contract~~ account classes, and the customer is an insurer subject to formal delinquency proceedings under the Liquidation Act, the FCM would be permitted to exercise the right to effect a cross-product liquidation, because the Liquidation Act does not stay the FCM's "contractual right to terminate, liquidate or close out any netting agreement or qualified financial contract with an insurer" because of the insurer's insolvency, financial condition or default or the commencement of a formal delinquency proceeding against the insurer.

(8) Safe Harbors as Applied to Cross-Affiliate Liquidation and Netting

If an uncleared swaps affiliate has a perfected security interest in a customer's ~~customer~~ account with an affiliated FCM, the uncleared swaps affiliate would generally have the contractual right to foreclose upon the proceeds of the customer's ~~customer~~ account, subject to the rights of the FCM under the customer agreement and applicable law. However, the uncleared swaps affiliate's right to take such action, even after the satisfaction of the customer's obligations to the FCM, would also be subject to the limitations imposed by the Liquidation Act, but for the safe harbors established for QFCs (which includes "swap agreements" within its definition). We have assumed that all uncleared swaps under the uncleared swaps agreement are "swap agreements" within the meaning of the Liquidation Act. Unless the transfer was made with "actual intent to hinder, delay or defraud," the Liquidation Act would prohibit the receiver from avoiding transfers of collateral made prior to the customer's delinquency proceeding, including the pledge of the amounts due to the customer from the FCM under the customer agreement, because that transfer would be made in connection with a swap agreement between the customer and the uncleared swaps affiliate. The cross-affiliate agreement provides the uncleared swaps affiliate with rights and remedies on a cross-product and cross-affiliate basis with respect to customer transactions and uncleared swaps entered into by the customer. Assuming that the commencement of delinquency proceedings would result in a default under the agreements between the delinquent insurer and the FCM, and between the delinquent insurer and the FCM's uncleared swaps affiliate, the Liquidation Act would permit each of the FCM and its uncleared swaps affiliate to liquidate, terminate, close out and net the related QFCs and netting agreements (*see* Section XI.A.4 for a discussion of the mechanics involved in cross-affiliate netting). The insurer-customer would typically also grant the FCM or uncleared swaps affiliate a security interest in the customer's account and its agreement with the other entity, including assets in its account with the other entity and amounts due to it from the other entity. Upon the declaration of a default by the FCM or uncleared swaps affiliate, the entity declaring the default would have the right to exercise the security interest in order to satisfy any shortfall in amounts

owed to it by the customer as a result of the default. Even if no default has occurred in one of the accounts, therefore, the FCM or uncleared swaps affiliate, as the case may be, would have the right to exercise its security interest in the non-defaulted account, foreclose on the account, liquidate the assets in the account and apply the proceeds to the satisfaction of any amounts due to it by the customer.

3. Insurers Receivership Model Act

The Receivership Act's QFC-related provisions are built on and largely mirror those of the Liquidation Act, but reflect revisions that generally clarify and strengthen the Liquidation Act's QFC definitions and operative provisions. Except for the differences discussed below, the relevant provisions of the Receivership Act are generally consistent with the Liquidation Act in relation to an FCM's termination, liquidation, close out and setoff rights.

(i) *Automatic Stay and Powers of the Receiver*

The Receivership Act, like the Liquidation Act, provides that the commencement of a delinquency proceeding operates as a stay,[676] applicable to all persons, of a broad set of actions, including, among other items: any act to obtain or retain possession of property of the insurer or of property from the insurer; any act to create, perfect or enforce any lien against property of the insurer; and termination, suspension of performance, declaration of default, demand for additional, substitute, or replacement security or performance, or other adverse action, with respect to any contract, agreement, or lease if the sole basis for the action is the fact that the insurer is the subject of delinquency proceedings.[677] Unlike the Liquidation Act, the Receivership Act explicitly provides in Section 108 (*Injunctions and Orders*) that the commencement of a delinquency proceeding does not operate as a stay or prohibition of, among other items: (1) setoff as permitted by Section 609 of the Receivership Act; or (2) "any right to cause the netting, liquidation, setoff, termination, acceleration or close out of obligations, or enforcement of any security agreement or arrangement or other credit enhancement or guarantee or reimbursement obligation, under or in connection with any netting agreement or qualified financial contract as provided for in Section 711."[678]

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676 The Receivership Act, unlike the Liquidation Act, does not refer to an "automatic stay by operation of law."

677 RECEIVERSHIP ACT § 108(~~E~~C).

678 *Id.* §§ 108(E)(4), (8). As both the Liquidation Act and Receivership Act's operative provisions respecting QFCs provide that "[n]otwithstanding any other provision of this Act, including any other provision of this Act permitting the modification of contracts, or other law of a state, no person shall be stayed or prohibited from exercising" the QFC safe-harbored rights, the exceptions to the stay in Section 108 provide additional clarification but do not alter the force of the QFC safe harbors set forth in the operative provisions. LIQUIDATION ACT § 46(A); RECEIVERSHIP ACT § 711(A).

The Receivership Act's definition of "delinquency proceeding" is substantively the same as the Liquidation Act but "formal delinquency proceeding" is defined to include, unlike the Liquidation Act, conservation proceedings in addition to rehabilitation and liquidation proceedings. Unlike the Liquidation Act, conservation proceedings may be instituted against domestic insurers (or in ancillary proceedings involving non-domestic insurers), but conservation is intended to be a short-term proceeding that will either be terminated or converted to a rehabilitation or liquidation.[679] Seizure orders are treated similarly to seizure orders under the Liquidation Act.

The powers granted to a receiver under the Receivership Act, although somewhat more detailed than the Liquidation Act, provide for similarly broad powers, including the power to transfer, assume or reject contracts of the insurer and to avoid fraudulent transfers and voidable preferences.

In light of the stay and avoidance powers set forth in the Receivership Act, absent the special treatment of QFCs as discussed below, the commencement of a formal delinquency proceeding against a customer under the Receivership Act would give the receiver the power to invalidate or reverse certain transactions that occurred between the FCM and the defaulting insurer prior to the commencement of the proceeding, and limit the FCM's ability to exercise its contractual rights against the defaulting customer. In the absence of the QFC safe harbors discussed below, these provisions would also permit a receiver to reverse pre-petition transfers of margin or other amounts by the customer to the FCM.

The Receivership Act further provides that "[n]either the filing of a petition commencing delinquency proceedings under this Act nor the entry of any order of seizure, conservation, rehabilitation or liquidation shall constitute a breach or an anticipatory breach of any contract or lease of the insurer."[680] Although the Liquidation Act authorizes the receiver to affirm or disaffirm contracts to which the delinquent insurer is a party, the Receivership Act contains a separate section not found in the Liquidation Act that provides certain conditions and procedures applicable to the assumption and rejection of executory contracts. Specifically, the receiver may assume or reject any executory contract or unexpired lease of the insurer, but if there has been a default thereunder (other than a default due to a breach relating to the insolvency or financial condition of the insurer, the appointment of a receiver under the Act, or satisfaction of any penalty rate arising from the non-performance of non-monetary obligations), the receiver may not assume the contract unless, at the time of the assumption, the receiver cures or provides adequate assurance that the receiver will promptly cure the default and the receiver provides adequate assurance of future performance under the contract.[681] In addition, a claim arising from the receiver's

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679 RECEIVERSHIP ACT §~~3(F~~ 302(A). As conservation proceedings are included within the defined term "formal delinquency proceedings," the QFC safe harbors in the Receivership Act would apply to conservation, rehabilitation or liquidation proceedings.

680 *Id.* § 209(B).

681 *Id.* § 114.

rejection of an executory contract is to be determined as though the claim had arisen before the date of the petition commencing the delinquency proceeding. As with the Liquidation Act, absent the special treatment of QFCs discussed below, even if a contract gives a party the right to terminate a contract upon the insurer's delinquency proceeding, that right cannot be exercised, and such post-petition limitations would significantly limit an FCM's rights following its customer's default.

(ii) *Qualified Financial Contract Safe Harbors*

Section 711 of the Receivership Act provides broad exceptions to the stay and the receiver's avoidance powers. Section 711(A) of the Liquidation Act provides:

> Notwithstanding any other provision of this Act, including any other provision of this Act permitting the modification of contracts, or other law of a state, no person shall be stayed or prohibited from exercising:
>
> (1) A contractual right[682] to cause the termination, liquidation, acceleration or close out of obligations under or in connection with any netting agreement or qualified financial contract with an insurer because of: (a) the insolvency, financial condition or default of the insurer at any time, provided that the right is enforceable under applicable law other than this Act; or (b) the commencement of a formal delinquency proceeding under this Act;
>
> (2) Any right under a pledge, security, collateral, reimbursement or guarantee agreement or arrangement or any other similar security arrangement or arrangement or other credit enhancement relating to one or more netting agreements or qualified financial contracts;

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682 "Contractual right" is defined to include "any right set forth in a rule or bylaw of a derivatives clearing organization (as defined in the Commodity Exchange Act), a multilateral clearing organization (as defined in the Federal Deposit Insurance Corporation Improvement Act of 1991), a national securities exchange, a national securities association, a securities clearing agency, a contract market designated under the Commodity Exchange Act, a derivatives transaction execution facility registered under the Commodity Exchange Act, or a board of trade (as defined in the Commodity Exchange Act) or in a resolution of the governing board thereof and any right, whether or not evidenced in writing, arising under statutory or common law, or under law merchant, or by reason of normal business practice." *Id.* § 711(G). This definition is substantially similar to the definition in the Liquidation Act, but adds additional facilities (*e.g.*, derivatives transaction execution facility), and includes "arising … by reason of normal business practice" in addition to the rights available under statutory or common law or under law merchant. *Id.*

(3) Subject to the Receivership Act's set off provision (discussed in Section XII.G.3.(iii) below), any right to set off or net out any termination value, payment amount, or other transfer obligation arising under or in connection with one or more qualified financial contracts where the counterparty or its guarantor is organized under the laws of the United States or a state or a foreign jurisdiction approved by the Securities Valuation Office (SVO) of the NAIC as eligible for netting;[683] or

(4) If a counterparty to a master netting agreement or a qualified financial contract with an insurer subject to a proceeding under this Act terminates, liquidates, closes out or accelerates the agreement or contract, damages shall be measured as of the date or dates of termination, liquidation, close out or acceleration. The amount of a claim for damages shall be actual direct compensatory damages calculated in accordance with Subsection F relating to disaffirmance or repudiation of contracts, as discussed in this Section XII.G.

The Receivership Act as compared to the Liquidation Act adds item (4) above to the operative provisions of the QFC safe harbors. This provision clarifies how damages are to be measured upon the termination, liquidation or close out of QFCs by a FCM and is basically the same principle that governs how damages are measured under the Liquidation Act (the Liquidation Act on its face limits this methodology to where the receiver disaffirms a QFC, although we believe it would be reasonable to interpret the Liquidation Act to apply the same methodology where the counterparty terminates, liquidates or closes out QFCs).

The QFC definitions in the Receivership Act are similar to those in the Liquidation Act, subject to certain clarifying improvements. For example, rather than providing independent definitions, the Receivership Act specifies that the terms "forward contract," "repurchase agreement," "securities contract" and "swap agreement" have the meanings given to them in the FDIA (12 U.S.C. § 1821(e)(8)(D)) "as amended from

683 The foregoing provisions are substantially similar to the Liquidation Act, save for certain clarifying improvements. For example, "acceleration" is added as a contractual right under the first prong, and the second prong is expanded to cover "reimbursement" agreements and replaces "other credit support document" with "other credit enhancement." In addition, whereas the Liquidation Act refers to "a" netting agreement or qualified financial contract in the second and third prongs, the Receivership Act refers to "one or more" netting agreements or qualified financial contracts.

time to time."[684] The Receivership Act defines the term "commodity contract"[685] in substantially the same way as the Liquidation Act, but clarifies that, in addition to the contract and transaction categories set forth in the Liquidation Act, "commodity contract" also includes any combination of such contracts or transactions or any option to enter into such. The Receivership Act definition of "netting agreement"[686] expands on that of the Liquidation Act by including any master agreement or bridge agreement, or any security agreement or arrangement or other credit enhancement or guarantee or reimbursement obligation, related to any contract or agreement described as a netting agreement under the definition.

(iii) *Set Off*

Like the Liquidation Act, Section 609 of the Receivership Act provides that, except for the specified exceptions discussed below, "mutual debts or mutual credits, whether arising out of one or more contracts between the insurer and another person in connection with any action or proceeding under this Act, shall be set off and the balance only shall be allowed or paid." Section 609(B) of the Receivership Act states, in pertinent part, that no setoff shall be allowed in favor of any person where: the claim

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684 RECEIVERSHIP ACT § 104(W)(2).

685 "Commodity contract" is defined to mean: "(a) A contract for the purchase or sale of a commodity for future delivery on, or subject to the rules of, a board of trade or contract market under the Commodity Exchange Act (7 U.S.C. § 1, *et seq*.) or a board of trade outside the United States; (b) An agreement that is subject to regulation under Section 19 of the Commodity Exchange Act (7 U.S.C. § 1, *et seq*.) and that is commonly known to the commodities trade as a margin account, margin contract, leverage account or leverage contract; (c) An agreement or transaction that is subject to regulation under Section 4c(b) of the Commodity Exchange Act (7 U.S.C. § 1, *et seq*.) and that is commonly known to the commodities trade as a commodity option; (d) Any combination of the agreements or transactions referred to in this paragraph; or (e) Any option to enter into an agreement or transaction referred to in this paragraph. *Id.* § 104(W)(1).

686 "Netting agreement" is defined to mean: "(1) a contract or agreement (including terms and conditions incorporated by reference therein), including a master agreement (which master agreement, together with all schedules, confirmations, definitions and addenda thereto and transactions under any thereof, shall be treated as one netting agreement), that documents one or more transactions between the parties to the agreement for or involving one or more qualified financial contracts and that provides for the netting, liquidation, setoff, termination, acceleration or close out under or in connection with one or more qualified financial contracts or present or future payment or delivery obligations or payment or delivery entitlements thereunder (including liquidation or close-out values relating to such obligations or entitlements) among the parties to the netting agreement; (2) any master agreement or bridge agreement for one or more master agreements described in Paragraph (1) of this subsection; or (3) any security agreement or arrangement or other credit enhancement or guarantee or reimbursement obligation related to any contract or agreement described in Paragraph (1) or (2) of this subsection; provided that any contract or agreement described in Paragraph (1) or (2) of this subsection relating to agreements or transactions that are not qualified financial contracts shall be deemed to be a netting agreement only with respect to those agreements or transactions that are qualified financial contracts." *Id.* § 104(Q).

against the insurer is disallowed;[687] the claim against the insurer was purchased by or transferred to the person on or after the filing of the receivership petition or within 120 days preceding the filing of the receivership petition; or the obligation of the person arises out of any avoidance action taken by the receiver (the other exceptions under Section 609(B) relate to affiliates, reinsurance counterparties or assessable members of an insurer). We have assumed in this memorandum that none of the setoff prohibitions under Section 609(B) of the Receivership Act would be applicable.

The QFC-related provisions in the Receivership Act pertaining to separate accounts, walk-away clauses, disapplication to affiliates of the insurer, transfers and repudiation, and fraudulent transfers and preferences, are in substance the same as those set forth in the Liquidation Act discussed in Section XII.G.2(ii) above.

4. New York Insurance Law

The New York Insurance Law is originally based on the old NAIC Uniform Insurers Liquidation Act but has incorporated certain elements from the Liquidation Act and the Receivership Act. The definitions and operative provisions relating to QFCs and netting agreements are nearly identical to those set forth in the Receivership Act.

(i) *Powers of the Receiver*

Unlike the NAIC Model Acts, New York's insurance insolvency law under New York Insurance Law Article 74 ("*NYIL Article 74*") does not provide for an automatic stay in the event of a delinquency proceeding. Rather, a court may, upon application of the New York Superintendent of Financial Services for an order to show cause or at any time thereafter, issue an injunction "restraining the insurer . . . . and all other persons from the transaction of its business or the waste or disposition of its property until further order of the court." The receivership court is further authorized to issue other injunctions or orders as the court deems necessary to prevent interference with the proceeding or the obtaining of preferences, attachments or other liens. In practice, the initial rehabilitation or liquidation orders issued by the receiver in New York will be very broad and have a similar effect as the automatic stay applicable upon the commencement of a filing under the NAIC Model Acts. A receiver appointed in delinquency proceedings (rehabilitation, liquidation or conservation)[688] under NYIL Article 74 is vested with very broad powers, differently worded and organized but of similar scope and effect as those provided to receivers under the NAIC Model Acts.

586.687 This language replaces, and clarifies some of the ambiguities in, the analogous Liquidation Act provision that prohibits offset where an "obligation of the insurer to the person would not at the date of the filing of a petition for liquidation entitle the person to share as a claimant in the assets of the insurer." *See supra* Section XII.G.2(ii)(3).

688 Conservation under NYIL Article 74 only applies to delinquency proceedings against foreign or alien insurers, and is not addressed in this memorandum.

Accordingly, absent the special treatment of QFCs as discussed below, the commencement of a formal delinquency proceeding against a customer under NYIL Article 74 would give the receiver the power to invalidate or reverse certain transactions that occurred between the FCM and the defaulting insurer prior to the commencement of the proceeding, and limit the FCM's ability to exercise its contractual rights against the defaulting customer. In the absence of the QFC safe harbors discussed below, these provisions would also permit a receiver to reverse pre-petition transfers of margin or other amounts by the customer to the FCM.

(ii) *QFC Provisions*

The provisions of NYIL Article 74 regarding liquidation, termination, close out and netting with respect to QFCs and netting agreements[689] are substantially similar to those of the Receivership Act, other than for the following exceptions:

- Section 7437 of NYIL Article 74 explicitly excludes from the QFC safe harbors any insurers licensed to write financial guaranty insurance. This memorandum does not address the delinquency proceeding of a financial guaranty insurer under the New York Insurance Law.

- The NYIL Article 74 QFC provisions do not contain a provision dis-applying the QFC safe harbors to affiliates of the insurer, such that the QFC safe harbors, unlike the NAIC Model Acts, would apply to QFC counterparties who are affiliates of the delinquent insurer.

- The definition of "commodity contract" incorporates the Receivership Act definition, but expands on that definition by also including "any other contract that is included from time to time as a commodity contract as defined in the [FDIA]."

- The definitions of "forward contract," "repurchase agreement," "securities contract" and "swap agreement" are the same as those in the Receivership Act, but do not refer to the provisions of the FDIA "as amended from time to time." These definitions would pick up the relevant QFC definitions of the FDIA enacted in 2005 and 2006, but could be interpreted to mean that future amendments to the FDIA may not automatically be incorporated.

- The QFC-related provision relating to separate accounts differs from those in the NAIC Model Acts, stating instead that all rights of a counterparty under this article shall apply to a netting agreement and a qualified financial contract entered into on behalf

689 N.Y. INS. LAW § 7437 (McKinney 2020).

of or allocated to the general account of the insurer or a separate account of the insurer, other than an insurer licensed to write financial guaranty insurance, if the assets of the separate account are available only to a counterparty to a netting agreement and a QFC entered into on behalf of, or allocated to, that separate account.[690]

(iii) *Setoff*

The list of circumstances in which setoff is not permitted under the New York Insurance Law is modeled on the Liquidation Act but is more limited. One such included circumstance provides that offset shall not be allowed where "the obligation of the insurer to such person would not at the date of the entry of any liquidation order, or otherwise … entitle him to share as a claimant in the assets of such insurer."[691] We have assumed in this memorandum that none of the setoff prohibitions under the New York Insurance Law would be applicable.

5. Other Covered Insurance Jurisdictions

The chart below: (i) indicates for each of the 50 states (other than New York), the District of Columbia and Puerto Rico, whether such jurisdiction contains within its insurance insolvency laws any of the QFC safe harbor provisions adopted by the NAIC; (ii) for those states that have adopted QFC safe harbor provisions (*i.e.*, Other Covered Insurance Jurisdictions), indicates whether the QFC-related insurance insolvency provisions are modeled after the Liquidation Act or the Receivership Act (or a combination thereof);[692] and (iii) for each Other Covered Insurance Jurisdiction, summarizes any material modifications in such state's insurance insolvency laws from the QFC-related provisions of the applicable NAIC Model Act.

As a general matter, each Other Covered Insurance Jurisdiction has adopted a version of the QFC definitions and operative provisions from the Liquidation Act or the Receivership Act, with various modifications or re-organizations thereof. The below chart only focuses on those modifications that we believe, based on a plain reading of the jurisdiction's insurance insolvency laws, would materially affect the conclusions we have provided with respect to the NAIC Model Acts or that substantively alter the meaning and effect of the applicable NAIC Model Act provision. *See* Section XII.G.1 for an explanation of the coverage of our analysis of the laws of Other Covered Insurance Jurisdictions. We have limited our analysis to the insurance insolvency laws of the Other Covered Insurance Jurisdictions and have not attempted to analyze whether or to what

690 *Id.* § 7437(h). The language in N.Y. Ins. Law § 7437(h) avoids the ambiguities in the analogous NAIC Model Act provisions but, we believe, has the same effect. *See supra* Section XII.G.2(ii)(1).

691 *See supra* Section XII.G.2(ii)(3).

692 Note this column only addresses the QFC-related provisions. Several states have adopted the Receivership Act's QFC provisions but follow the Liquidation Act for other sections of their insurance insolvency laws (*e.g.*, the setoff provisions may follow the Liquidation Act but the QFC provisions the Receivership Act).

extent other laws (including other insurance laws) or regulations of such states could adversely affect, impair or conflict with the QFC safe harbors and related rights under discussion.

Note that the insurance insolvency laws of the Other Covered Insurance Jurisdictions vary in respect of the scope and procedures applicable to seizure orders and conservation proceedings; the chart below covers, and we have analyzed, only the effect of rehabilitation and liquidation proceedings under the insurance insolvency laws of the Other Covered Insurance Jurisdictions, and this memorandum and the chart below do not cover the potential effect of seizure orders or conservation proceedings in Other Covered Insurance Jurisdictions. Finally, note that very few of the Other Covered Jurisdictions impose an automatic stay upon the commencement of delinquency proceedings, but we believe the powers vested in receivers thereunder, and the authority of receivers and receivership courts to issue and grant broad injunctions thereunder, would have similar effects (absent the QFC safe harbors) on the termination, liquidation, close out and netting rights of FCMs as the automatic stay under the NAIC Model Acts.[693]

XIII. RELIANCE

We are furnishing this memorandum solely to FIA and ISDA for the benefit and use of the FCMs covered by Section II that are members of one or both of FIA and ISDA and affiliates of such FCMs (collectively, "*advisees*"). This memorandum is not to be relied upon, used, circulated, quoted or otherwise referred to for any other purpose by any other person or entity, except that the auditors of an advisee may rely upon this memorandum solely as evidential support for evaluating management's assertions with respect to the presentation on its financial statements of the FCM's transactions with a customer that is covered by Section II. In addition, a copy of this memorandum may be shown to any governmental authority pursuant to requirements of applicable law or regulations. In authorizing advisees to make copies of this memorandum available to such auditors or any governmental authority for such purposes, we are not undertaking or assuming any duty or obligation to such auditors or any governmental authority or establishing any lawyer-client relationship with them and do not undertake or assume any responsibility with respect to the preparation of financial statements or regulatory filings by or for any person or entity.

The opinions expressed herein are rendered on and as of the date hereof, and we assume no obligation to advise any advisees, such auditors or any governmental authority, or any other person or entity, or to make any investigations, as to any legal developments or factual matters arising subsequent to the date hereof that might affect the opinions expressed herein.

693 *See supra* Section XII.G.4(i) (discussing the New York Insurance Law in regard to this point).

OTHER COVERED INSURANCE JURISDICTIONS

Jurisdiction	*QFC Safe Harbors*	*Citation*	*NAIC Model Act Relationship to QFC Provisions*	*Material Differences from NAIC Model Acts*
Alabama	None	ALA. CODE §§ 27-32-1 to 27-32-41		
Alaska	None	ALASKA STAT. §§ 21.78.010 to 21.78.330		
Arizona	Yes	ARIZ. REV. STAT. ANN. §§ 20-611 to 20-650	Receivership Act	Definitions of "swap agreement," "forward contract," "securities contract," and "repurchase agreement" do not refer to provisions of the FDIA "as amended from time to time" but "as amended." This definition would pick up the relevant QFC definitions of the FDIA enacted in 2005 and 2006, but could be interpreted to mean that future amendments to the FDIA may not automatically be incorporated. Definition of "commodity contract" inadvertently refers to Section 6c(b) of the CEA (7 ~~USC §~~ U.S.C. § 6c(b) (2012)) in connection with commodity options, whereas the correct reference (as in the NAIC Model Acts) is Section 4c(b) of the CEA. As Section 6c(b) is the actual U.S. Code reference, this should not present any issues.
Arkansas	None	ARK. CODE ANN. §§ 23-68-101 to 23-68-135		
California	None	CAL. INS. CODE §§ 1010 to 1044, 1063.6, 1064.1 to 1064.13		
Colorado	Yes	COLO. REV. STAT. §§ 10-3-501 to 10-3-559	Receivership Act	The Colorado insurance law does not provide a definition for "netting agreement." The QFC provisions, however, make multiple references to "netting agreements" and we believe it is likely a Colorado court would look to the Receivership Act's definition thereof since the QFC provisions largely derive therefrom. The language for determining reasonable measures of damages follows the Liquidation Act as opposed to the Receivership Act (see ~~footnote~~ *supra* note 675~~ above).~~).

Jurisdiction	*QFC Safe Harbors*	*Citation*	*NAIC Model Act Relationship to QFC Provisions*	*Material Differences from NAIC Model Acts*
Connecticut	Yes	CONN. GEN. STAT. §§ 38a-903 to 38a-961	Liquidation Act	N/A
Delaware	Yes	DEL. CODE ANN. tit. 18, §§ 5901 to 5944	Receivership Act	Definition of "commodity contract" inadvertently refers to Section 6c(b) of the CEA (7 ~~USC §~~ U.S.C. § 6c(b) (2006)) in connection with commodity options, whereas the correct reference (as in the NAIC Model Acts) is Section 4c(b) of the CEA. As Section 6c(b) is the actual U.S. Code reference, this should not present any issues. Likewise, refers to Section 23 of the CEA in connection with margin accounts, margin contracts, leverage accounts and leverage contracts, whereas the correct reference is Section 19 (7 ~~USC §~~ U.S.C. § 23). Definition of "contractual right" follows the Liquidation Act as opposed to the Receivership Act.
District of Columbia	None	D.C. CODE §§ 31-1301 to 31-1357		
Florida	None	FLA. STAT. §§ 631.001 to 631.401		
Georgia	None	GA. CODE ANN. §§ 33-37-1 to 33-37-58		
Hawaii	None	HAW. REV. STAT. §§ 431:15-101 to 431:15-411		
Idaho	None	IDAHO CODE ANN. §§ 41-3301 to 41-3360		
Illinois	Yes	215 ILL. COMP. STAT. 5/187 to 5/221.13	Receivership Act	Broader than Receivership Act insofar as the QFC provision relating to fraudulent conveyances and preferences does not include the right of the receiver to avoid a transfer made with actual intent to hinder, delay or defraud.
Indiana	Yes	IND. CODE §§ 27-9-1-1 to 27-9-4-10	Liquidation Act	Definition of "netting agreement" differs significantly from the definitions in either NAIC Model Act, is potentially more restrictive in scope, especially as regards cross-product rights, and does

Jurisdiction	*QFC Safe Harbors*	*Citation*	*NAIC Model Act Relationship to QFC Provisions*	*Material Differences from NAIC Model Acts*
				not explicitly capture a master agreement concept.[694] Definitions of "swap agreement," "forward contract," "securities contract," and "repurchase agreement" do not refer to provisions of the FDIA "as amended from time to time." This definition would pick up the relevant QFC definitions of the FDIA enacted in 2005 and 2006, but could be interpreted to mean that future amendments to the FDIA may not automatically be incorporated. No provision dis-applying the QFC safe harbors to affiliates of the delinquent insurer.
Iowa	Yes	IOWA CODE §§- 507C.1 to 507C.60	Liquidation Act	N/A
Kansas	Yes	KAN. STAT. ANN. §§- 40-3605 to 40-3659	Receivership Act	Definition of "commodity contract" inadvertently refers to Section- 6c(b) of the CEA (7 ~~USC §~~ U.S.C. § 6c(b) (2006)) in connection with commodity options, whereas the correct reference (as in the NAIC Model Acts) is Section- 4c(b) of the CEA. As Section- 6c(b) is the actual U.S. Code reference, this should not present any issues. Likewise, refers to Section- 23 of the CEA in connection with margin accounts, margin contracts, leverage accounts and leverage contracts, whereas the correct reference is Section- 19 (7 ~~USC §~~ U.S.C. § 23).

694 Section 27-9-3.1-6 of the Indiana Insurance Law provides: "(a) As used in this chapter, 'netting agreement' means a new agreement that: (1) allows the parties to a previous agreement to aggregate the amounts owing by each party under all transactions that are outstanding under the previous agreement; and (2) replaces the amounts owing under the previous agreement with a single net amount: (A) resulting from the aggregation under subdivision (1); and (B) owing: (i) by one (1) party; and (ii) to the other party; to the previous agreement. (b) The single net amount described in subsection (a)(2) may be determined as follows: (1) In the event of a relevant default (including counterparty bankruptcy) as specified in the previous agreement, all transactions of a certain type are netted at: (A) market value; or (B) if: (i) otherwise specified in the contract; or (ii) market value is impossible to obtain; an amount equal to the loss suffered by the nondefaulting party as a result of the default. (2) Under the new agreement, the parties agree that legal obligations of the parties to make required payments under at least one (1) series of related transactions under the previous agreement are: (A) canceled; and (B) replaced by a new legal obligation to make payments on only the single net amount under the new agreement. (3) In the event of a cash settled trade, the parties agree that legal obligations of: (A) the parties; or (B) a party and parents or affiliates of a party; under related or unrelated transactions are canceled and replaced by the cash settled trade."

Jurisdiction	*QFC Safe Harbors*	*Citation*	*NAIC Model Act Relationship to QFC Provisions*	*Material Differences from NAIC Model Acts*
				Definitions of "swap agreement," "forward contract," "securities contract," and "repurchase agreement" do not refer to provisions of the FDIA "as amended from time to time." This definition would pick up the relevant QFC definitions of the FDIA enacted in 2005 and 2006, but could be interpreted to mean that future amendments to the FDIA may not automatically be incorporated.
Kentucky	None	KY. REV. STAT. ANN. §§ 304.33-010 to 304.33-600		
Louisiana	None	LA. REV. STAT. ANN. §§ 22:2001 to 22:2045		
Maine	Yes	ME. REV. STAT. ANN. tit. 24-A, §§ 4351 to 4407	Receivership ~~act~~Act	N/A
Maryland	Yes	MD. CODE ANN., INS. §§ 9-201 to 9-232	Liquidation Act	N/A
Massachusetts	Yes	MASS. GEN. LAWS. ANN. ch. 175 §§ 180A to 180L	Receivership Act	Definitions of "swap agreement," "forward contract," "securities contract," and "repurchase agreement" do not refer to provisions of the FDIA "as amended from time to time" but "as amended." This definition would pick up the relevant QFC definitions of the FDIA enacted in 2005 and 2006, but could be interpreted to mean that future amendments to the FDIA may not automatically be incorporated. The provision permitting setoffs by its terms only applies to mutual debts or mutual credits arising out of one or more contracts between an insolvent insurer and another insurer. It would seem given the QFC safe harbor language that this limitation on offsets (i.e., only permitted between insurers) should not affect the separately granted QFC safe harbor rights of a QFC counterparty to exercise setoff and netting rights.
Michigan	Yes	MICH. COMP. LAWS ch. 500, §§ 8101 to 8159	Liquidation Act	Definition of "commodity contract" inadvertently refers to Section 6c(b) of the CEA (7 ~~USC §~~ U.S.C. § 6c(b) (2006)) in connection with commodity options, whereas the correct reference (as in the NAIC Model Acts) is Section 4c(b) of the CEA. As

Jurisdiction	*QFC Safe Harbors*	*Citation*	*NAIC Model Act Relationship to QFC Provisions*	*Material Differences from NAIC Model Acts*
				Section 6c(b) is the actual U.S. Code reference, this should not present any issues. Likewise, refers to Section 23 of the CEA in connection with margin accounts, margin contracts, leverage accounts and leverage contracts, whereas the correct reference is Section 19 (7 ~~USC §~~ U.S.C. § 23).
Minnesota	Yes	MINN. STAT. §§ 60B.01 to 60B.61	Receivership Act	N/A
Mississippi	None	MISS. CODE ANN. §§ 83-24-1 to 83-24-117 (1991/2000) (previous version of model); §§ 83-23-1 to 83-23-9		
Missouri	Yes	MO. REV. STAT. §§ 375.1150 to 375.1246; 375.535 to 375.780; §§ 375.950 to 375.990	Receivership Act	Definitions of "swap agreement," "forward contract," "securities contract," and "repurchase agreement" do not refer to provisions of the FDIA "as amended from time to time" but "as amended." This definition would pick up the relevant QFC definitions of the FDIA enacted in 2005 and 2006, but could be interpreted to mean that future amendments to the FDIA may not automatically be incorporated. Note the Missouri Insurance Law provision regarding the liquidator's rights to repudiate contracts (§ 375.1184) includes a written agreement requirement similar to that in the FDIA, whereby "an agreement which tends to diminish or defeat the interest of the liquidator shall not be valid against the liquidator" unless it is in writing, was executed by the insurer and the counterparty contemporaneously with the acquisition of the asset, was approved by the insurer's board of directors, and has been continuously maintained as an official record of the insurer.
Montana	None	MONT. CODE ANN. §§ 33-2-1301 to 33-2-1394		
Nebraska	Yes	NEB. REV. STAT. §§ 44-4801 to 44-4862	Liquidation Act	Although the terms appear in the definition of "qualified financial contract," the Nebraska Insurance Law does not provide separate definitions for "commodity contract," "swap agreement," "forward contract,"

Jurisdiction	*QFC Safe Harbors*	*Citation*	*NAIC Model Act Relationship to QFC Provisions*	*Material Differences from NAIC Model Acts*
				"securities contract," or "repurchase agreement." We would expect a Nebraska court to look to the correlative definitions in the Liquidation Act since the QFC provisions are derived therefrom.
Nevada	None	NEV. REV. STAT. §§ 696B.010 to 696B.570		
New Hampshire	None	N.H. REV. STAT. ANN. §§ 402-C:1 to 402-C:61		
New Jersey	Yes	N.J. STAT. ANN. §§ 17B:32-31 to 17B:32-92; 17:30C-1 to 17:30C-31	Receivership Act	New Jersey has two insurance insolvency statutes; the one modeled after the Receivership Act and containing the QFC safe harbors is part of New Jersey's Life and Health Insurance Code and by its terms **only applies to insurers in the business of life insurance, health insurance or annuities**. Definitions of "swap agreement," "forward contract," "securities contract," and "repurchase agreement" do not refer to provisions of the FDIA "as amended from time to time." This definition would pick up the relevant QFC definitions of the FDIA enacted in 2005 and 2006, but could be interpreted to mean that future amendments to the FDIA may not automatically be incorporated. The language for determining reasonable measures of damages follows the Liquidation Act as opposed to the Receivership Act (see ~~footnote~~*supra* note 675~~ above)~~.). No provision dis-applying the QFC safe harbors to affiliates of the delinquent insurer.
New Mexico	None	N.M. STAT. ANN. §§ 59A-41-1 to 59A-41-57		
North Carolina	None	N.C. GEN. STAT. §§ 58-30-1 to 58-30-310		
North Dakota	None	N.D. CENT. CODE §§ 26.1-06.1-01 to 26.1-06.1-59		

Jurisdiction	*QFC Safe Harbors*	*Citation*	*NAIC Model Act Relationship to QFC Provisions*	*Material Differences from NAIC Model Acts*
Ohio	Yes	OHIO REV. CODE ANN. §§ 3903.01 to 3903.99	Receivership Act (with elements of Liquidation Act)	"Netting agreement" definition is substantially similar to Receivership Act definition but excludes the language clarifying that master agreements and all schedules, confirmations, etc. thereto are treated as one netting agreement; and uses in both definition of "netting agreement" and operative QFC safe harbor provisions the formulation (similar to Liquidation Act) of "a" qualified financial contract or netting agreement as opposed to "one or more" qualified financial contracts or netting agreements. (*See* ~~footnote~~*supra* note 686.)
Oklahoma	None	OKLA. STAT. tit. 36, §§ 1801 to 1812; 1901 to 1938		
Oregon	None	OR. REV. STAT. §§ 734.014 to 734.440		
Pennsylvania	None	40 PA. STAT. ANN. §§ 221.1 to 221.63		
Puerto Rico	None	P.R. LAWS ANN. tit. 26, §§ 4001 to 4054		
Rhode Island	None (pending)	R.I. GEN. LAWS §§ 27-14.3-1 to 27-14.3-65; 27-14.4-1 to 27-14.4-23	Bill (~~I SB 788~~HB 5643) is pending in state legislature to add QFC provisions from the Receivership Act to Rhode Island's existing insurance insolvency law	
South Carolina	None	S.C. CODE ANN. §§ 38-27-10 to 38-27-1000		
South Dakota	None	S.D. CODIFIED LAWS §§ 58-29B-1 to 58-29B-161		
Tennessee	Yes	TENN. CODE ANN. §§ 56-9-101 to 56-9-510	Receivership Act	Definition of "qualified financial contract" differs from NAIC Model Acts by adding: "provided, that the insurer entered into such contract or agreement in accordance with: (i) Section 56-3-303(a)(21) [a provision that sets forth the types of hedging and derivatives transactions and investments that

Jurisdiction	*QFC Safe Harbors*	*Citation*	*NAIC Model Act Relationship to QFC Provisions*	*Material Differences from NAIC Model Acts*
				domestic life insurance companies are permitted to invest in]; and (ii) the insurer's derivative instruments use plan that has been approved by the commissioner pursuant to § 56-3-303(a)(21) [also only applicable to **domestic life insurance companies**]. Accordingly, QFCs eligible for the QFC safe harbors must also comply with certain insurance investment laws applicable **only to domestic life insurance companies**, such that the QFC safe harbors are arguably only available to domestic life insurers (or insurers that otherwise comply with such insurance investment laws). Definition of "commodity contract" inadvertently refers to Section 6c(b) of the CEA (7 ~~USC §~~ U.S.C. § 6c(b) (2006)) in connection with commodity options, whereas the correct reference (as in the NAIC Model Acts) is Section 4c(b) of the CEA. As Section 6c(b) is the actual U.S. Code reference, this should not present any issues. Likewise, refers to Section 23 of the CEA in connection with margin accounts, margin contracts, leverage accounts and leverage contracts, whereas the correct reference is Section 19 (7 ~~USC §~~ U.S.C. § 23).
Texas	Yes	TEX. INS. CODE ANN. §§ 443.001 to 443.402	Liquidation Act	N/A
Utah	Yes	UTAH CODE ANN. §§ 31A-27a-101 to 31A-27a-902	Receivership Act	Definitions of "swap agreement," "forward contract," "securities contract," and "repurchase agreement" do not refer to provisions of the FDIA "as amended from time to time." This definition would pick up the relevant QFC definitions of the FDIA enacted in 2005 and 2006, but could be interpreted to mean that future amendments to the FDIA may not automatically be incorporated.
Vermont	None	VT. STAT. ANN. tit. 8, §§ 7031 to 7100		
Virginia	Yes	VA. CODE ANN. §§ 38.2-1500 to 38.2-1522	Receivership Act	Definitions of "swap agreement," "forward contract," "securities contract," and "repurchase agreement" do not refer to provisions of the FDIA "as amended from time to time" but "as amended." This definition would pick up the relevant QFC definitions of the FDIA

Jurisdiction	*QFC Safe Harbors*	*Citation*	*NAIC Model Act Relationship to QFC Provisions*	*Material Differences from NAIC Model Acts*
				enacted in 2005 and 2006, but could be interpreted to mean that future amendments to the FDIA may not automatically be incorporated. Qualifies disaffirmance/repudiation provision by stating that the disaffirmance or repudiation of QFCs or netting agreements by the receiver must be within a reasonable time period following commencement of delinquency proceedings.
Washington	None	WASH. REV. CODE ANN. §§ 48.31.010 to 48.31.900; 48.99.010 to 48.99.900		
West Virginia	None	W. VA. CODE §§ 33-10-1 to 33-10-41		
Wisconsin	Yes	WIS. STAT. §§ 645.01 to 645.90	Receivership Act	Definitions of "swap agreement," "forward contract," "securities contract," and "repurchase agreement" do not refer to provisions of the FDIA "as amended from time to time." This definition would pick up the relevant QFC definitions of the FDIA enacted in 2005 and 2006, but could be interpreted to mean that future amendments to the FDIA may not automatically be incorporated. The QFC safe harbors **do not apply to QFCs entered into with an insurer authorized to write financial guaranty insurance** (defined to not include credit insurance or mortgage guaranty insurance, all as defined under the Wisconsin Insurance Law). Broader than Receivership Act insofar as the QFC provision relating to fraudulent conveyances and preferences does not include the right of the receiver to avoid a transfer made with actual intent to hinder, delay or defraud. QFC separate account provision clarifies that all rights of counterparties that apply to netting agreements and QFCs "entered into on behalf of a separate account are available only to counterparties of netting agreements and qualified financial contracts entered into on behalf of that separate account."
Wyoming	None	WYO. STAT. ANN. §§ 26-		

Jurisdiction	*QFC Safe Harbors*	*Citation*	*NAIC Model Act Relationship to QFC Provisions*	*Material Differences from NAIC Model Acts*
		28-101 to 26-28-131		

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As noted above, this memorandum is limited to the ~~Federal~~federal laws of the United States and the laws of the State of New York, and we are expressing no opinion as to the effect of the laws of any other jurisdiction except to the extent expressly set forth above. In addition, please see the last paragraph of Section I above.

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