

ENERGY DERIVATIVES: WHICH COUNTRY (U.S. OR U.K.) PROVIDES THE BEST CUSTOMER ASSET PROTECTIONS TO AN ENERGY TRADING FIRM IF ITS BROKERAGE FIRM/COUNTERPARTY FILES FOR BANKRUPTCY?

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Synopsis: Energy firms trade a variety of financial products. Two important financial products involve energy futures contracts and energy over-the-counter (OTC) derivatives. Historically, energy futures contracts have been heavily regulated, whereas energy OTC derivatives were not subject to regulation prior to the enactment of the Dodd-Frank Act in July 2010, but are now the subject of many new laws and regulations both in the United States and globally. The principal financial centers, where these energy products are bought and sold, are in New York City and London. These cities have major exchanges where energy futures contracts are traded, and both are the headquarters for the principal offices of most of the world's largest banks and brokerage firms that offer these energy products to their clients. The 2008 financial crisis led to some major bankruptcies and near collapses of other large financial institutions. If an energy-trading firm wants to trade these financial products, it needs to understand which laws and regulations (United States. vs. United Kingdom) provide greater protections if its financial firm files for bankruptcy. This article will analyze the legal and regulatory differences between the United States and the United Kingdom regarding customer asset protections and financial firm bankruptcies and will offer some best practices for energy trading firms to consider when selecting its financial firm.

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Over the past eight years or so, we have seen some very large brokerage firms file for bankruptcy. They include Lehman Brothers in September 2008 and MF Global in October 2011.[1] Other firms, such as Bear Stearns and AIG Insurance Company, would have filed for bankruptcy but for some intervening events.[2] Other financial firms came close to filing. These financial firms are located around the globe, but the two major financial centers are New York and London. Exchanges that offer energy products are located in both cities. The world's largest banks and brokerage firms have their headquarters or large principal offices in both of these cities. Since the 2008 financial crisis, there have also been major legislative and regulatory changes on a global basis, affecting the trading of derivatives and financial institutions engaged in such trading. What has not changed are the global bankruptcy laws that apply in the event the financial firm fails. This article will address the different legal and regulatory landscapes in both the United States and the United Kingdom that protect the assets of energy-trading firms that are held directly by financial firms in these two countries and what happens to such assets when the respective financial firm files for bankruptcy. It shall also address legislative and regulatory changes still needed and best practices energy trading firms should consider when doing business with U.S. and U.K. financial firms.

I. INTRODUCTION

I teach several courses at New York Law School including, among others, Securities Regulation, Derivatives Market Regulation, and Regulation of Broker-Dealers and Futures Commission Merchants. In each course, there are one or more classes on the bankruptcy of financial firms and how customer assets held by the financial firms are or are not protected in such bankruptcies. As I start to discuss these customer asset protection issues, I always ask my students the following question: "In your checking account, albeit probably one with a small amount, do you care what the bank does with your funds?" Of course, they all respond "Yes," but then I explain how the Federal Deposit Insurance Corporation (FDIC) protects banking customers by providing a government-backed insurance program that

1. See Part 5 for a greater discussion of the bankruptcy of these two large financial firms.

2. Bear Stearns was sold to JP Morgan over a weekend in March 2008, and AIG Insurance Company would have filed for bankruptcy but for the $185 billion bailout by the U.S. Government on September 16, 2008, one day after Lehman Brothers filed for bankruptcy.

pays up to $250,000 if the underlying bank fails.[3] The students then feel somewhat better for some reason, but they still believe the bank should not be allowed to do whatever it wants with their deposits. I then explain how the Securities Investor Protection Corporation (SIPC), another government-sponsored insurance program, protects customers of a broker-dealer (BD) (e.g., a stock brokerage firm) by paying up to $500,000 if the BD fails.[4] Most law students are not as interested as only a few have ever opened a stock brokerage account. Then, I discuss how futures and derivatives customers of a U.S. Futures Commission Merchant (FCM) have no such government-sponsored insurance program to protect them in the unlikely event the FCM files for bankruptcy.[5] They then have a puzzled look on their faces, as if they were silently asking "why not?" The absence of a government-sponsored insurance program for derivatives thus requires energy firms that trade derivatives to focus on the applicable laws and regulations that apply regarding how their assets, which are held at a financial firm, are protected in the event the financial firm fails.

This article will discuss the various laws and regulations, here in the United States and in the United Kingdom, if a U.S. or a U.K. futures and OTC derivatives financial firm files for bankruptcy and how customer assets are protected in each country. These customer asset laws and regulations refer to a concept of customer segregation in the United States and client money rules in the United Kingdom. While similar in nature, there are some major differences between the U.S. and U.K. customer asset protection regimes. These differences require energy trading firms to consider where to do their futures and OTC derivatives trading activities.

There are also some major differences in the bankruptcy laws in both of these countries. In fact, the United States has some very specific laws in the U.S. Bankruptcy Code, as will be explained below, that deal with the bankruptcy of a stock brokerage firm and with the bankruptcy of a commodity brokerage firm. Most other countries around the globe treat a bankruptcy of a financial firm, which holds customer assets, approximately the same as if any other corporation files for bankruptcy in that country. In other words, customers of a bankrupt financial firm may not necessarily receive any special treatment or consideration and may even be treated as an unsecured creditor of the bankrupt estate. When Lehman Brothers filed for bankruptcy in September 2008, the bankruptcy laws in each country in which it had an office differed, and those differences have not changed to date. On the other hand, these special U.S. bankruptcy laws are unique. They also deal with a concept called "specifically identifiable property." Normally, if a financial firm files for bankruptcy, a trustee or an administrator is appointed to deal with the bankrupt estate, to collect assets of the bankrupt entity and to distribute those assets to the entity's creditors in accordance with the local bankruptcy laws. If property can be identified specifically, then that specific property will normally, under most bankruptcy laws, be distributed back to its beneficial owner. On the other hand, sometimes that property must be sold and converted to cash. Under

3. FEDERAL DEPOSIT INSURANCE CORPORATION, www.fdic.gov (last updated July 19, 2016); 12 U.S.C. §§ 1811, 1821(a)(1)(E).

4. SECURITIES INVESTOR PROTECTION CORPORATION, www.sipc.org (last visited Oct. 3, 2016).

5. NAT'L FUTURES ASS'N, CUSTOMER ASSET PROTECTION INSURANCE FOR U.S. FUTURES CUSTOMERS (2013), https://www.nfa.futures.org/news/insurance-study.html.

this circumstance, the identity of that property is erased, and the cash is never deemed to be specifically identifiable property. With cash, there is no identifiable beneficial owner, and the cash will be distributed on a collective basis. It is these differences, in law and in regulations, which energy firms must consider when selecting their financial firm.

II. HOW ENERGY FIRMS USE DERIVATIVES

Energy firms trade a variety of financial products, in particular, derivatives. There are two basic types of derivatives—exchange-traded derivatives (ETD) and OTC derivatives. OTC derivatives are commonly referred to as swaps. Before the enactment of the Dodd-Frank Act in July 2010,[6] OTC derivatives were mostly an unregulated financial product that had a notional value globally of nearly $500 trillion.[7] This exemption from regulation within the United States resulted from another law, the Commodity Futures Modernization Act of 2000 (CFMA), which was enacted by Congress in 2000.[8] Title III of the CFMA exempted OTC derivatives from being subject to the federal securities laws and the federal commodities laws, although it did preserve the right of a counterparty to be protected in the event of any fraudulent practices by the other counterparty.[9] As noted below, ETDs are subject to significant laws and regulations, including: regulations promulgated by the U.S. Commodity Futures Trading Commission (CFTC), the U.S. federal regulatory agency that has jurisdiction over futures and swaps; the National Futures Association (NFA), the futures and swap industry self-regulatory organization that is subject to oversight regulation by the CFTC; the exchanges upon which ETD products are traded in the United States; and the Financial Conduct Authority (FCA), the U.K. principal regulatory agency for U.K. financial firms. These laws and regulations deal extensively with many important issues, including the requirements for registration, disclosures, reporting and recordkeeping and, as this article will discuss, how customer assets held by a U.S. financial firm, commonly known as a Futures Commission Merchant (FCM), or by a U.K. investment firm, are to be regulated and protected and what happens to such customer assets if the respective financial firm files for bankruptcy.[10] An FCM is the entity required to register with the CFTC, as only FCMs may hold customer assets when an energy trading firm trades futures and swaps that are cleared through a U.S. central counterparty (CCP), commonly known as a clearing house. A U.K. investment firm must be authorized, which is similar to registration, with the FCA. Lehman Brothers and MF Global were both registered as an FCM when they filed for bankruptcy as noted above, and each had major U.K. affiliates.[11]

6. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

7. *OTC Derivatives Statistics at End-December 2015*, BANK FOR INT'L SETTLEMENTS (May 2016), https://www.bis.org/publ/otc_hy1605.htm.

8. Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763; Commodity Exchange Act, 7 U.S.C. §§ 1-25 (2001).

9. Regulation of Derivative Financial Instruments (Swaps, Options and Futures), by Ronald Filler and Jerry Markham ("Filler & Markham"), 267-273

10. *See* Commodity Exchange Act §§ 1a(28), 4d, 7 U.S.C. 1a(28), 6d

11. Both Lehman Brothers Inc. and MF Global Inc. were registered as a broker-dealer (BD) with the U.S. Securities and Exchange Commission (SEC). Thus, these firms were dually registered as both a FCM and

However, customers of these two firms received different protections as all of the futures customers immediately received 100% of their assets when Lehman Brothers here in the United States filed for bankruptcy in September 2008, whereas customers of MF Global here in the United States only received at first approximately 70% of their assets, when MF Global filed for bankruptcy in October 2011, as there was a shortfall of approximately $1.2 billion on the date of the filing of its bankruptcy petition.[12] The U.K. affiliates of both of these firms also received different treatment as will be discussed below.

Energy firms trade a large amount of both ETD and OTC derivatives (e.g., swaps). The exchange-traded derivatives include futures contracts and options on futures contracts on such energy products as crude oil, Brent oil, natural gas, and heating oil. These energy futures contracts are principally traded on exchanges located in New York and London.

If the energy firm desires to trade futures, it simply opens a futures account with an FCM. A futures account at an FCM involves two fundamental activities—the execution or trading of the futures order and the clearing of the futures contracts through a clearinghouse or CCP, once they are executed. As required by law, all futures contracts must be traded on an exchange and cleared through a clearinghouse.[13] Thus, the clearinghouse provides the financial integrity over futures and options on futures contracts as it guarantees the performance of these products traded between the buyer and the seller. In essence, the clearing house stands in the shoes of the seller to the buyer and in the shoes of the buyer to the seller. If either the buyer or seller defaults for any reason, the other party, which would have made a trading profit that day, will be guaranteed to receive that trading profit at the end of the respective closing day by the clearinghouse. In the futures world, it is called a "zero sum game." For each dollar made by one of the parties to the futures contract, the other party must automatically lose that dollar, or whatever the respective amount is each day. Then, at the end of the trading day, the party which made the trading profit will actually have that amount deposited in its trading account at the end of the closing day. The clearinghouse guarantees this performance.

If, however, the energy firm desires to trade OTC energy derivatives, then it becomes a party to a bilateral agreement, known as the ISDA Master Agreement. The other counterparty typically is a dealer, commonly known as a swap dealer. Accordingly, prior to the enactment of the Dodd-Frank Act, there was no clearinghouse associated with swap transactions. Therefore, an energy firm, which is a counterparty to an OTC derivative, is subject to the credit risk of the other counterparty. If the other counterparty fails, e.g., breaches on its obligations as set forth in the ISDA Master Agreement, then that agreement dictates if and how the non-defaulting counterparty will receive the amounts owed to it by the defaulting counterparty. Title VII of the Dodd-Frank Act changed all of that and, in essence, repealed the exemption from regulation that had existed during the 2008 financial

as a BD. As will be noted below, the U.S. Bankruptcy Code has different provisions applicable to FCMs and BDs.

12. *See* Part 5 below for a more detailed description of what happened when these two firms filed for bankruptcy.

13. Commodity Exchange Act § 4d(a)(2), 7 U.S.C. 6d(a)(2)

crisis.[14] Title VII of the Dodd-Frank Act, known as the "Wall Street Transparency and Accountability Act", also changed one other major aspect of how derivatives are now to be regulated.[15] It expanded the term "commodity interests" under the Commodity Exchange Act to now include "swaps," a defined financial product.[16] Prior to the Dodd-Frank Act, this term only applied to futures contracts and options on futures contracts. This legislative change increased dramatically the jurisdiction of the CFTC, especially given the notional size of the OTC derivatives market.[17] Most of the more regulatory changes adopted recently by the CFTC solely involve swaps.

When Lehman Brothers failed in September 2008, it had approximately 930,000 OTC derivative contracts on its books. This meant 930,000 counterparties were at credit risk on this single day. The Dodd-Frank Act changed all of that with respect to OTC derivatives, as Title VII of the Dodd-Frank Act required the same two activities that futures contracts have been historically subject to, namely execution and clearing, to apply to swaps. OTC derivatives are now, for the most part, subject to mandatory execution and clearing of OTC derivatives. Of course, there are many exceptions to this, and many of those exceptions apply to energy firms which use OTC derivatives for bona fide hedging purposes.[18]

In addition, energy firms are subject to numerous other regulations including, but not limited to, registrations and licensing, trade reporting, transmissions, position limits, record-keeping requirements, etc., that are promulgated by two principal U.S. regulatory agencies—the CFTC and the Federal Energy Regulatory Commission (FERC). However, these other regulatory matters will not be addressed in this article. Also, this article will focus primarily on the Commodity Exchange Act and applicable CFTC regulations and will not address FERC regulations.

Derivatives products are inherently risky in nature as they are highly leveraged financial products. Energy firms that trade derivatives are normally willing to assume the underlying market risks associated with derivatives. What they do not want, nor do any customers, is to lose their assets due to the bankruptcy of their financial firm.

III. THE U.S. CUSTOMER ASSET PROTECTION REGIME — CUSTOMER

14. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010); Filler & Markham, *supra* note 9.

15. Dodd-Frank Wall Street Reform and Consumer Protection Act §§ 701-74.

16. Commodity Exchange Act § 2(a)(1) (granting "exclusive jurisdiction" to the CFTC to regulate futures, options on futures, and swaps).

17. The Dodd-Frank Act divided jurisdiction of OTC derivatives between the SEC and the CFTC, with the CFTC having jurisdiction over "swaps" and the SEC having jurisdiction over "security-based swaps." Based solely on the notional value of swaps versus security-based swaps, this meant the CFTC would have jurisdiction over more than 90% of the notional value of OTC derivatives, with the smaller balance being delegated to the SEC.

18. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, 1675 (2010); *see also* Final Rule, *End-User Exception to the Clearing Requirement for Swaps*, 77 Fed. Reg. 42,560, 42,572 n.59 (2012).

SEGREGATION

As briefly noted above, there is no U.S. government-sponsored insurance plan that provides financial reimbursement assistance to customers of a failed financial firm (e.g., a FCM) that provides execution and clearing services for both energy futures and OTC energy derivatives. Instead, the United States Congress back in 1936, with the adoption of the Commodity Exchange Act, created a legislative package to protect futures customers that still exists in principle today.[19] That legislative package, as explained below, has been vastly augmented by regulations adopted by the CFTC, by compliance rules adopted by the NFA and by rules adopted by the various U.S. futures exchanges and clearinghouses.[20]

The United States Congress, in adopting the Commodity Exchange Act (CEA) in 1936, added Section 4d(a)(2). This section states, among other things:

> It shall be unlawful for any person to be a futures commission merchant unless . . . such person shall, whether a member or nonmember of a contract market . . . 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*.[21]

The "*as belonging to such customer"* language is the critical language in the CEA that has provided important protections to futures customers, wherever they are located globally, to be protected if they, directly or indirectly through an omnibus account have opened, a futures account with a U.S. FCM.[22] This legislative language, coupled with the underlying regulations, require the FCM to establish a separate and distinct "Customer Segregated Account" at an independent custodial bank[23] and that this property (e.g., the assets held in the Customer Segregated Account) shall be deemed to be "customer property" that does not belong to the FCM or to any creditors of the FCM if that FCM files for bankruptcy.[24] This is a critical element as customers of a failed FCM become the most secured creditors of that failed FCM. The reason: all property held in a Customer Segregated Account shall therefore *belong to such customers* of that FCM, and no other creditors of that failed FCM are entitled to any of the assets held in the customer segregated account. That is why these accounts are deemed to be "protected" accounts. In essence, picture a ring fence around these protected accounts, and no other creditor can reach into the ring to get paid on any debts owed by that FCM to that creditor. All of the assets within that ring belong *solely to the* customers of that FCM. Therefore, if an FCM files for bankruptcy, as will be noted below, in the absence of any shortfall of amounts held in the customer segregated account, all customers of that failed FCM will receive all of their assets held in that protected account shortly after the FCM files for bankruptcy. This occurred with Lehman Brothers in September 2008. On the other hand, if there is a shortfall in the amount of

19. Commodity Exchange Act §§ 1 et al.

20. Ronald Filler, *Are Customer Segregated/Secured Amount Funds Properly Protected After Lehman?*, 28 FUT & DERIV. L. REP 1, 3 (Nov. 2008).

21. 7 U.S.C. § 6d(a)(2) (emphasis added).

22. Commodity Exchange Act §§ 1 et al.

23. 17 C.F.R. § 1.20(b) (2014).

24. 17 C.F.R. § 1.23(a) (2014).

assets that should have been held and maintained in that protected segregated account, then the remaining customers will receive an amount of assets on a *pro rata* basis. This is what happened initially when MF Global filed for bankruptcy in October 2011.[25]

A. Types of Futures Customer Accounts

An FCM must open three separate and distinct accounts at a custodial bank to hold customer assets depending on what the customer property will be used to trade in.[26] If the customer desires to trade futures on a U.S. futures exchange,[27] then all such customer assets used to margin or fund the U.S. futures contracts shall be held in a "Customer Segregated Account".[28] If the customer desires instead to trade futures on a non-U.S. futures exchange, as permitted by Part 30 of the CFTC regulations,[29] then the FCM must deposit the customer assets in a different protected account at the custodial bank, called the Secured Amount Account.[30] The third such customer protected account is required for customers who desire to trade a cleared swap through a FCM.[31] This third account is thus referred to as a Cleared Swap Account.[32] All three of these accounts are to be treated as separate and distinct accounts on the books of the FCM. In the unlikely event of an FCM filing for bankruptcy and if a shortfall hypothetically occurs in only one of these three accounts, then the customer assets held in the respective shortfall account will be treated differently and be required to share the shortfall on a pro rata basis without imposing any obligations on the other two accounts that did not have a shortfall at the time of the FCM's bankruptcy.[33] Customers with assets deposited in the other two accounts, in this example, since they experienced no shortfall at the time of the FCM's bankruptcy, will receive 100% of their assets back shortly after the bankruptcy.

25. On a personal note, I left Lehman Brothers to join the NYLS Faculty several months before Lehman filed for bankruptcy on September 15, 2008. I got a call that morning from my former boss at Lehman who asked me to come to Lehman's offices to assist in the transfer of customer open positions and customer funds held at Lehman on behalf of its global futures customers. By the end of that week, or by September 19, 2008, every open futures position and all customer funds were either transferred to another FCM or the positions were liquidated at the request of the respective customer and the funds were returned back to the customer's bank accounts without a dollar lost. However, we all learned a very important issue that week, that is, the bankruptcy laws of other countries do not favorably compare to the U.S. Bankruptcy Code which provides, as discussed below in Part 5, important safeguards and protections to futures customers of a failed FCM. In fact, the bankruptcy laws of these other non-U.S. countries can work against protecting customers whose assets are held in the foreign jurisdiction to margin its global futures positions.

26. *See* 17 C.F.R. § 1.20(b) (the custodial bank must satisfy certain conditions and may not be affiliated with the FCM).

27. The legal term for a U.S. futures exchange is a Designated Contract Market (DCM) but a futures exchange is also commonly referred to as a board of trade or just an exchange.

28. 17 C.F.R. § 1.20(a) (2014).

29. 17 C.F.R. § 30.3(a) (1996).

30. 17 C.F.R. § 30.7 (2014).

31. Cleared swap accounts evolved from the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), P.L. 111-203, 124 Stat. 1376 (2010), enacted in July 2010. This new law will be discussed in greater detail later in this article.

32. 17 C.F.R. § 22.1.

33. *See generally* 17 C.F.R. pt. 190 (2013); 11 U.S.C. § 766 (2005); *See also* section on "The U.S. Bankruptcy Code and CFTC Part 190 – The Bankruptcy Rules" *infra*.

1. Customer Segregated Accounts

As noted above, the requirement for an FCM to establish a customer segregated account evolved from Section 4d(a)(2) of the CEA.[34] CFTC Regulation 1.20 expanded this legislative requirement by requiring FCMs to "separately account for all futures customers funds," to "deposit futures customer funds under an account name that clearly identifies them as futures customer funds," and to "at all times maintain . . . money, securities and property in an amount at least sufficient in the aggregate to cover its total obligations to all futures customers."[35] CFTC Rule 1.20 also requires an FCM to:

- Place all customer funds with a certain type of depository;[36]
- Receive a written acknowledgement from each such depository, other than a derivatives clearing organization (DCO),[37] that acknowledges that the funds held in the underlying segregated account constitute customer funds and that the depository may not attach a lien on any such funds as a result of any obligations owed by the respective FCM to that depository;[38]
- Only use a depository that agrees to provide direct, read-only electronic access of all transactions and account balances to the CFTC;[39]
- Not commingle futures customer funds with funds deposited by the FCM itself[40] or by 30.7 customers;[41] and
- Treat all moneys, securities and property held in the segregated account "as belonging to such futures customer. A futures commission merchant shall not use the funds of a futures customer to secure or guarantee the commodity interests, or to secure or extend credit, of any person other than the futures customer for whom the funds are held."[42]

The amounts held in the segregated account must be accounted for daily.[43] The account balances are also reported daily via electronic feeds to the CFTC, the NFA,[44] and the CME.[45] This daily feed came about as a result of the failure of

34. Filler, *supra* note 20, at 3.

35. 17 C.F.R. § 1.20(a).

36. *Id.* § 1.20(b). The permissible depositories include a bank or trust company, a derivatives clearing organization (DCO), also commonly known as a clearing house, or with another FCM.

37. A Derivatives Clearing Organization, or DCO, is the legal name for a clearing house.

38. 17 C.F.R. § 1.20(d). *See* Appendix A to CFTC Rule 1.20 for the required language to be included in any such written acknowledgement. These written acknowledgements must be obtained from all depositories, other than DCOs, regardless of the location of the customer funds account.

39. 17 C.F.R. §§ 1.20(d)(3)(i)-(ii). This daily direct electronic feeds must also be filed with each designated self-regulatory organizations (DSRO) which, in today's world, includes the National Futures Association and the Chicago Mercantile Exchange (CME).

40. *Id.* § 1.20(e)(2).

41. *Id.* § 1.20(e)(3).

42. *Id.* § 1.20(f). Note the language "as belonging to such futures customer" tracts the language in Section 4d(a)(2) of the CEA noted above. These new regulations were added in 2014.

43. 17 C.F.R. § 1.32. *See also* the section on "Recent Regulatory Changes" *infra*.

44. The NFA receives the daily reports only from FCMs that are not clearing member firms.

45. The CME receives the daily reports from FCMs that are clearing member firms.

Peregrine Financial Group.[46] These daily feeds have provided important data to the regulators as both the FCM and all of the depositories provide their respective account balances, which the regulators can account for to determine the accuracy and completeness of the respective account balances each and every day. The regulators may apply a small difference each day, around 2% to 4%, of any differences in the numbers provided by the FCM versus its depositories, but this new daily feed has provided tremendously important data to regulators regarding these segregated accounts; thus, establishing greater customer protections.[47] Recently, based on a difference of approximately $5.0 million in these daily reports for a smaller FCM, the CFTC brought an enforcement action against that FCM which resulted in a large fine.[48]

Another issue relating to Customer Segregated Accounts involves the concept of residual interest.[49] An FCM will normally deposit a sizeable amount of its own capital into its Customer Segregated Account to ensure that no shortfall will occur in the protected account.[50] If a shortfall does occur, that is, the amount held in the segregated account is less than the amount that should have been held, the FCM must give prompt and immediate notice to the regulators and will then be required to close down. There is no cure period for a FCM if a shortfall occurs.

As noted above, CFTC Rule 1.20(e) prohibits a FCM from commingling its own funds with customer funds.[51] However, when a FCM deposits its own funds in the Customer Segregated Account, e.g., the residual interest amount, its funds are deemed to be "customer funds" as long as the FCM's capital is held in the Customer Segregated Account.[52] Thus, if the FCM files for bankruptcy, its capital deposited and held in the Customer Segregated Account may not be returned back to the FCM for the benefit of its creditors until all customer funds have been returned back in whole to the futures customers. Keep in mind that customer funds, especially when the customers trade on non-U.S. markets, could take one or more days for the respective currency to be deposited in the account. This extra layer provides some important assurance that no shortfall will occur.[53]

Today, each FCM must account for and disclose the amount of the residual interest (e.g., its own capital) in the protected customer asset account held at the FCM. The residual interest, as just noted, plays a key role to prevent or at least

46. See *infra* Section VI.

47. A small difference may occur as it will depend on when amounts hit these accounts at the end of each day. Some deposits may not show up on the books until the next business day.

48. Press Release, U.S. Commodity Futures Trading Comm'n, CFTC Orders Chicago-Based Cunningham Commodities, LLC and its Controller Salvatore Carmen Russo Jointly to Pay a $150,000 Penalty for Failing to Immediately Report a Segregated Account Deficiency (May 9, 2016), http://www.cftc.gov/PressRoom/PressReleases/pr7366-16; Cunningham Commodities, LLC, C.F.T.C. Docket No. 16-15 (2016) (Order Instituting Proceedings).

49. 17 C.F.R. § 1.23; Press Release, U.S. Commodity Futures Trading Comm'n, CFTC Staff Issues Residual Interest Deadline Report (May 12, 2016), http://www.cftc.gov/PressRoom/PressReleases/pr7369-16.

50. 17 C.F.R. § 1.23(c) (2014).

51. Commodity Exchange Act §§ 1 et al., 17 C.F.R. § 1.20.

52. 17 C.F.R. § 1.20.

53. When I was a Managing Director in the Global Futures Department at Lehman Brothers, we would hold anywhere between $200 to $400 million of Lehman's capital in the Customer Segregated Account just to ensure that there would never be a shortfall.

minimize a shortfall from occurring. FCMs may increase or decrease the amount of its residual interest held in the protected account from time-to-time. For example, let's assume a large customer transfers its futures account from one FCM to another FCM. When such an account transfer occurs, normally the open futures positions are transferred to the new receiving FCM as of the close of business on a designated trading day, with the underlying cash or equity in those customer accounts used to margin the open positions at the other FCM coming over one or more days after the positions were transferred. This particular position transfer is known as an ex-pit transfer.[54] If the amount of the transfer is quite large, let's say over $100,000,000 of margin in size, the FCM may want to increase the amount of its residual interest held in the customer segregated account until the margin equity of that customer is actually received by the FCM. Then, once the equity is received by the receiving FCM, this new capital infusion may be removed. It should be noted that, after MF Global filed for bankruptcy in October 2011, the NFA adopted a new rule that requires a FCM wanting to withdraw more than 25% of the amount of its residual interest held in the Customer Segregated Account to obtain the prior written approval of the CEO, or his/her designee of the FCM before making such a large withdrawal and to notify its designated self-regulatory organization (CME or NFA) and the CFTC promptly of any such large withdrawn amount.[55] This rule is colloquially referred to as the "Jon Corzine Rule".[56]

2. Secured Amount Account

As noted above, if a U.S. customer of a FCM desires to trade futures contracts on a non-U.S. futures exchange, then the customer funds must be held in a separate customer funds account, called the Secured Amount Account or the 30.7 Account.[57] The 30.7 Account is treated identical to the Customer Segregated Account and has the same rules as noted above. Here, the customer funds are held outside the United States, typically with a clearing member firm of the non-U.S. futures exchange or with the non-U.S. clearinghouse depending on the facts. Just like Customer Segregated Accounts, the FCM must receive a written acknowledgement from each non-U.S. depository.[58] To obtain the required funds to be held in the 30.7 Account, the FCM may direct its customers to deposit such amounts directly in the respective 30.7 Account at the depository or to deposit such amounts initially in the Customer Segregated Account of the FCM. The FCM will then transfer the customer funds from the 1.20 Account to the 30.7 Account and vice versa. The key issue here is that these accounts, e.g., the 1.20 Account and the 30.7 Account, are to be treated separate and distinct from each

54. *Understanding "Ex-Pit" Transactions*, CME GR. (Oct. 27, 2011), http://www.cmegroup.com/education/featured-reports/understanding-ex-pit-transactions.html.

55. See Section 16 of the NFA'S Manual, entitled "FCM Financial Practices and Excess Segregated Funds/Secured Amount/Cleared Swaps Customer Collateral Disbursements," which can be found at www.nfa.futures.org.

56. Mr. Corzine was the CEO of MF Global at the time of its bankruptcy in October 2011. At that time, there was an alleged shortfall of over $1.2 billion in the Customer Segregated Account of MF Global. This shortfall has since been repaid. Ann Saphir, *"Corizone Rule" Proposed for Futures Brokers*, REUTERS (May 29, 2012), http://www.reuters.com/article/us-mfglobal-collapse-corzine-rule-idUSBRE84S1GJ20120529.

57. 17 C.F.R. § 30.7(a).

58. *Id.* § 30.7(d).

other, and a shortfall in one of these accounts does not directly impact the other protected account. This is also true for the Cleared Swap Accounts under Part 22 of the CFTC Rules as noted below.

Each FCM must also provide a daily direct electronic feed of the amounts it holds in its 30.7 Account.[59] The various depositories do the same so U.S. regulators can analyze the data and determine whether the differences being reported by the FCM and all of its depositories are significant or not.[60]

3. Cleared Swap Accounts

The third customer protected account was established by the CFTC following the enactment of the Dodd-Frank Act. As noted above, this new law now required most OTC derivatives to be traded on an exchange and cleared through a clearing house. Part 22 of the CFTC rules followed.[61] Therefore, every OTC counterparty is now required to clear its swaps unless an exemption from the mandatory swap clearing requirement applies.[62] One such exemption from the mandatory clearing requirement applies to counterparties known as commercial end users, such as most energy firms, provided they have entered into the swap agreement for bona-fide hedging purposes.[63]

One key regulatory change adopted by the CFTC that involves cleared swaps is the so-called legally separated but operationally commingled (LSOC) Rule.[64] The LSOC rule permits the commingling of cleared swap margins, just like the other two customer protected accounts just noted, but does not permit a CCP[65] to apply to funds deposited by non-defaulting cleared swap customers to satisfy any shortfall in the FCM's cleared swap account at the DCO.[66] Therefore, the concept of "fellow customer risk," as noted in this article, does not apply to cleared swaps. To provide such protection, the FCM provides information to the respective DCO regarding positions of each respective cleared swap customer. Whereas with respect to futures positions, all futures positions are held in an omnibus type account at the CCP such that the CCP does not know the positions held by each respective futures customer of the FCM. Therefore, if a FCM fails, the non-defaulting cleared swap customers should not be subject to any risks associated with its FCM's bankruptcy.[67]

59. *Id.* § 30.7(d)(3).

60. *Id.* § 30.7(d); *see* Part 4 below on "The U.S. Bankruptcy Code and CFTC Part 190 – The Bankruptcy Rules."

61. 17 C.F.R. pt. 22 (2014).

62. 17 C.F.R. § 22.2.

63. This exemption only applies to certain commercial end users which use OTC derivatives for bona-fide hedging purposes.

64. *LSOC and Cleared Swap Customer Protection*, CME GR., http://www.cmegroup.com/clearing/risk-management/lsoc-cleared-swaps-customer-protection.html (last visited Oct. 4, 2016).

65. A clearinghouse or CCP is formally known as a "derivatives clearing organization" ("DCO").

66. 17 C.F.R. § 22.2(c), (e).

67. One possible fallacy of the LSOC Rule, and Part 22 of the CFTC Rules, is that the U.S. Bankruptcy Code has not been changed. See Part 5 on the "U.S. Bankruptcy Code and CFTC Part 190— the Bankruptcy Rules" below for greater analysis and discussion. The U.S. Bankruptcy Code still has language dealing with the *pro rata* treatment of customers of a failed FCM and does not distinguish between futures and cleared swaps. If

IV. PART 3 – THE U.K. CUSTOMER ASSET PROTECTION REGIME – CLIENT MONEY

U.K. financial firms are required to hold customer property in a client money account or the client money pool (CMP).[68] Unlike the United States, where customers directly deposit their funds into the FCM's Customer Segregated Account at the respective custodial bank, in the United Kingdom investment firms typically use an alternate approach as customer property is initially sent directly to the financial firm which then transfers such funds into the Client Money Account.[69] This is a major difference from what happens if the financial firm never makes such a transfer into the client money account or files for bankruptcy prior to such transfer. That is exactly what happened at both Lehman Brothers and MF Global.[70] In the case of Lehman Brothers, its U.K. affiliate, Lehman Brothers International (Europe) (LBIE), filed for bankruptcy on September 15, 2008.[71] In the United States, Lehman Brothers Inc., which was registered as a broker-dealer with the SEC and as a FCM with the CFTC, did not file for bankruptcy until after the close on Friday, September 19, 2008.[72] These five days were critical in distinguishing what happened in the United States versus the United Kingdom. What became apparent following LBIE's bankruptcy was LBIE had not forwarded all of the customer assets into the protected Client Money Account.[73] This resulted in two classes of customers at LBIE, those whose funds were properly deposited into the Client Money Account and those whose funds were never transferred.[74] The customers whose funds were transferred would receive preferential treatment versus those whose assets were not transferred. The U.K. Administrator held that they would be treated, in essence, as unsecured creditors of LBIE's bankruptcy estate.[75] Litigation followed and the case went all the way to the U.K. Supreme Court, which resolved the following issues:

- Whether the client monies not transferred into the Client Money Account should be treated equitably with the customer funds held in accordance with the CASS7 rules;

an FCM fails in the future, it will be interesting to see if the trustee appointed will follow the Code or the LSOC Rule.

68. Financial Services and Markets Act 2000, c. 8, § 139, (Eng). U.K. client money rules are reflected in Chapter 7 of the Client Assets Sourcebook (CASS 7), and are commonly referred to as the CASS7 Rules.

69. For a through explanation of how the U.K. client money account rules work see Ronald Filler, *Consumer Protection: How U.K. Client Money Rules Differ From U.S. Customer Segregated Rules When a Custodian Firm Fails to Treat Customer Property Properly*, 24 J. TAX'N & REG. FIN. INST. 25 (May/June 2011); Ronald Filler, *Ask The Professor: What is the Impact on MF Global From the Recent UK Supreme Court Decision Involving Lehman Brothers International (Europe)?*, 32 FUT. & DERIV. L. REP. 1 (Apr. 2012) (hereinafter "U.K. LBIE Case") [hereinafter *Impact on MF Global*].

70. *In re* Lehman Bros. Int'l (Europe), [2012] UKSC 6, [1]-[3] (appeal taken from Eng.).

71. *Id.* at [24].

72. *Id.*

73. *Id.* at [4].

74. *Id.* at [4]-[5].

75. *In re Leham Bros. Int'l (Europe)*, [2012] UKSC 6, [5]-[20].

- Whether the statutory trust established by the client money rules takes effect immediately upon receipt of the client monies by the investment firm or only upon their deposit into the Client Money Account;
- Whether CASS7 rules require the client money pooling of all identifiable customer property wherever located or just the funds actually held in the Client Money Account; and
- Whether all customers have a contractual right to participate in any distribution from the CMP or does this right apply solely to customers whose funds were directly transferred into the CMP.[76]

The U.K. Supreme Court held that LBIE customers, whose assets were not transferred into the CMP should receive the same protection as those LBIE customers whose assets were properly transferred.[77] The Court stated:

> Where money is received from a client, or from a third party on behalf of a client, it would be unnatural, and contrary to the primary purpose of client protection, for the money to cease to be the client's property on receipt, and for it (or its substitute) to become property again on segregation.[78]

Thus, customer property still held at the investment firm that can be identified as customer property should receive the protected treatment. The true purpose of the CASS7 protective scheme was to provide a high level of protection for all clients, including those clients whose funds were still held by the investment firm.[79] The U.K. Supreme Court then stated:

> To exclude identifiable client money in house accounts from the distribution regime runs counter to this policy. It recreates what was referred to in argument as a 'bifurcated' scheme which provides clients with different levels of protection, namely a right to claim in the CMP under the CASS 7 rules for those whose money is held in segregated client accounts . . . . The purpose of the scheme . . . is to provide a high level of protection to *all* clients and in respect of client money held in *each* money account of the firm.[80]

This U.K. Supreme Court decision was important to all customers of a failed U.K. financial firm as it added important protections in the event the U.K. financial firm did not properly forward customer assets to the protected "Client Money" account. In the U.S., as noted above, customer assets are directly transferred into the protected account at the custodian bank by the customer whereas the U.K. regulatory regime requires the financial firm to make the necessary transfer of customer assets into the protected account. However, it should be noted that the LBIE case before the U.K. Supreme Court dealt solely with cash held by LBIE that was not forwarded to the Client Money Account by LBIE. The MF Global bankruptcy dealt with a different issue, that is, whether U.S. Treasuries or other government securities held by MF Global U.K. Limited (MF Global U.K.), the U.K. affiliate of MF Global Inc., the U.S. registered broker-dealer and FCM, would be treated differently by the U.K. courts. KMPG LLP was appointed as the

76. *Id.*; *See* Filler, *supra* note 69.
77. *In re Leham Bros. Int'l (Europe)*, [2012] UKSC 6, [157].
78. *Id.* at [63].
79. *Id.* at [165].
80. *Id.* (emphasis in original).

Administrator of MF Global U.K.[81] The U.K. Administrator[82] issued a report which stated the U.S. SIPC Trustee for MF Global, Inc., had presented a claim for over $742 million from the U.K. estate.[83] This case was settled between the U.K. Administrator and the U.S. SIPC Trustee before any court decision was rendered, so no new case law has occurred. However, the key difference between the Lehman U.K. bankruptcy and the MF Global U.K. bankruptcy dealt with whether a bankruptcy law should treat cash held by the bankrupt firm differently than government securities or other identifiable property which is held in the name of the underlying customer by the financial firm. This issue will be discussed in greater detail below.

V. THE U.S. BANKRUPTCY CODE AND CFTC PART 190— THE BANKRUPTCY RULES

One of the main differences between the United States and other countries, including the United Kingdom, is that the U.S. Bankruptcy Code (the Code)[84] provides specific language regarding the bankruptcy of both securities and commodity firms.[85] Subchapter III of Chapter 7 of the Code deals with stockbroker liquidation.[86] Subchapter IV of Chapter 7 of the Code deals with commodity broker liquidation.[87] In particular, Subchapter IV provides:

- Each customer account of the bankrupt FCM shall be deemed a separate account and the net equity in each customer account may not be offset against the net equity in another customer's account;[88]
- Certain transfers other than transfers regarding customer property may be avoided and the underlying property so transferred shall be deemed customer property but no transfer made within seven days of the bankruptcy order shall be avoided provided the CFTC has approved the transfer;[89]
- The trustee may take certain actions regarding open futures customers of the bankrupt FCM provided such actions does not adversely impact other customers;[90]

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81. MF GLOBAL BANKR. ADMIN., http://www.mfglobalcaseinfo.com (last visited Sept. 2, 2016).

82. The role of the "U.K. Administrator" is quite similar in nature to the role played by the SIPC Trustee in connection with a broker-dealer insolvency.

83. In re MF Global UK Limited [2012] EWHC 9527 (Ch) [42] (Eng.).

84. 11 U.S.C. § 101 (2010).

85. *Id.* §§ 701-84.

86. *Id.* §§ 741-53.

87. *Id.* §§ 761-67.

88. *Id.* § 763.

89. 11 U.S.C. § 764. *See also* Ronald Filler, *The Seventh Circuit and Sentinel— Five Times a Charm!*, 35 Fut. & Deriv. L. Rep. 2 (Apr. 2016). The 7th Circuit issued five different opinions following the bankruptcy of Sentinel Management Company, an FCM, in August 2007. This article analyzes these five opinions as the underlying cases dealt with the rights of the trustee in bankruptcy in connection with transfers being avoided.

90. 11 U.S.C. § 766.

- The trustee shall liquidate open futures contracts in the customer's account and thus reduce them to money, except for those customers who have issued instructions to the contrary;[91] and
- Such customer property shall be distributed ratably to the customers of the bankrupt FCM based on their net equity claims.[92]

It is also important to note that this last provision of the Code plays a critical role if (a) there is a FCM bankruptcy, and (b) there is a shortfall in one of the three types of U.S. customer protected accounts listed above. In such an event, the remaining futures customers, whose assets are held in the account subject to the shortfall, will be treated on a *pro rata* basis, meaning that each customer will receive an equal percentage of its assets held in the protected account. This concept is known as "fellow customer risk." For example, assume a shortfall did occur equaling 5% of the total amount that should have been held in the respective customer segregated account. Therefore, each customer would receive up to 95% of its net equity amount. The trustee in bankruptcy appointed by the Bankruptcy Court will then try and collect assets to make up this 5% shortfall. As noted below, this is what occurred with MF Global.

In addition, the CFTC has issued Part 190 of its regulations, which further expand on matters relating to a FCM's bankruptcy.[93] In particular, Part 190 spells out some key issues, namely:

- A FCM must, at the time a futures account is opened, provide a disclosure document to every futures customer which explains the potential risks associated with the bankruptcy of the FCM; and
- All property in the futures customer's account shall be treated as cash.[94]

This is a very unique concept. In all other bankruptcies, if the underlying property involves a "specifically identifiable property," then such property, because it can be identified as belonging to a particular beneficial owner, shall be given to that person. Pursuant to the CFTC Part 190 rules, if a futures customer deposits U.S. Treasury bills (T-Bills) in its futures account to satisfy its margin requirements, such T-Bills shall be treated as "cash" even though those T-Bills are identified as belonging to a specific futures customer. Thus, if an FCM files for bankruptcy and a futures customer has deposited T-Bills in its futures account at the FCM, the trustee must sell those T-Bills and convert them to cash.[95] This

91. *Id.* § 766(e), (f). *See also* 17 C.F.R. §1.3(z) (2016). The CFTC has issued regulations which protect customers who are deemed to be a bona-fide hedger pursuant to CFTC Rule 1.3(z) so that their open futures positions are not liquidated by the trustee. To provide such instruction and notice, bona-fide hedgers sign a Hedge Designation Letter at the time the futures account is opened at the FCM.

92. 11 U.S.C. § 766(h). This pro-rata treatment of customer property of a bankrupt FCM, as noted above, can result in the customers not receiving full value if there is a shortfall in the Customer Segregated Account of the FCM. This is commonly referred to as "fellow customer risk." As noted in this article, customers of both MF Global and Peregrine Financial Group (PFG) did not receive full value of their net equity amounts. To date, this is still true for PFG whereas futures customers of MF Global did eventually, after a few years, receive 100% of their net equity claims.

93. *See generally* 17 C.F.R. pt. 190.

94. *Id.* § 190.10.

95. 11 U.S.C. § 766(f).

conversion of specifically identifiable property does not apply when a broker-dealer files for bankruptcy or in bankruptcies that take place in any other country. It is unique and applies solely to a FCM's bankruptcy. Therefore, it is always recommended that, if the choice exists, it is always better for a customer to use collateral other than cash to meet one's margin or other financial obligations if permitted to do so. Accordingly, if a customer does open an account with a U.K. firm, that customer should only deposit acceptable government securities or other property (typically U.K. gilts although several non-U.S. clearing houses also accept T-Bills) to satisfy its initial margin requirements to preserve its rights to receive back that specific property as such property is identified as belonging to that particular customer.

VI. LEHMAN BROTHERS AND MF GLOBAL

Lehman Brothers Holdings, Inc., the parent company of Lehman Brothers Inc. (LBI), filed for bankruptcy on September 15, 2008. LBI was registered as a BD with the SEC and as a FCM with the CFTC. A key issue involving the Lehman bankruptcy is LBI had the requisite regulatory capital to continue to act as a BD and as a FCM during the week of September 15-19, 2008.[96] By the close of business on Friday, September 19, 2008, all open futures positions, cash and other property held by Lehman Brothers on behalf of its futures customers were either transferred to other FCMs or returned back to the customers, without one dollar lost.[97]

This was not the case with MF Global.[98] When MF Global filed for bankruptcy on October 31, 2011, there was a shortfall in its Customer Segregated Account of approximately $1.2 billion.[99] Obviously, this was an unprecedented FCM bankruptcy. To be honest, I am unaware of any published report which has properly explained what exactly happened at MF Global that caused this large shortfall. There is a pending CFTC enforcement action against Jon Corzine, its CEO, and Edith O'Brien, an Assistant Treasurer, but, nearly five years later, this administrative action is still pending.[100] However, as noted above, the futures customers at MF Global were eventually paid in full, meaning that their net equity claims were paid in full by the Trustee.[101]

96. Filler, *supra* note 20.

97. *Id.*

98. *See generally* Ronald Filler, *What Did MF Global Do?*, 31 Fut. & Deriv. L. Rep. 8 (Nov. 2011); *Impact on MF Global*, *supra* note 69.

99. *Id.* supra 1, n.4.

100. Press Release, U.S. Commodity Futures Trading Comm'n, CFTC Charges MF Global Inc., Mf Global Holdings Ltd., Former CEO Jon S. Corzine, and Former Employee Edith O'Brien for MF Global's Unlawful Misuse of Nearly One Billion Dollars of Customers Funds and Related Violations (June 27, 2013), http://www.cftc.gov/PressRoom/PressReleases/pr6626-13.

101. *Impact on MF Global*, *supra* note 69.

Peregrine Futures Group (PFG), another FCM, also filed for bankruptcy in July 2012 with a shortfall in its Customer Segregated Account of over $200 million.[102] I served on a Special Committee formed by the NFA which analyzed the PFG matter and the NFA's role as the PFG auditor.[103] The firm, Berkeley Research Group (BRG), was selected by the NFA to conduct a thorough review of NFA's audit practices. BRG found that the CEO of PFG created a scheme to defraud PFG and that NFA properly fulfilled its auditing requirements.[104] This bankruptcy case is still pending.

VII. RECENT REGULATORY CHANGES

There have been three major recent regulatory changes, which, I believe, will provide greater customer protections and hopefully minimize, if not prevent, the failure of another major FCM. Two of these changes were initially adopted by the NFA and were later adopted as well by the CFTC. The third recent change involved solely a new CFTC rule.

The two recent changes initially adopted by the NFA were noted above. One such change, commonly referred to as the "Jon Corzine Rule," requires each FCM, which withdraws 25% or more of the residual interest, e.g., the amount of capital deposited by the FCM in one of the three customer protected accounts (customer segregated account, secured amount account and cleared swap account), to first notify the various regulators (CFTC, NFA and CME) before the withdrawal can occur.[105] The withdrawal must also be signed and approved by the CEO, or a designee, of the FCM.[106] This 25% withdrawal rule is designed to prevent a FCM from withdrawing a sizeable amount of its own capital that was deposited in a protected customer account without first requiring the CEO to approve the withdrawal and then to give immediate notice of any such large withdrawal to the regulators so they can take whatever corrective action may be needed.

A second recent change, also noted above, requires each FCM and every depository, which holds customer assets on behalf of the FCM, to provide a daily report evidencing the amount of customer assets held in each of the three customer asset accounts.[107] These daily reports are filed with the CME by FCMs that are CME clearing member firms and with the NFA for FCMs that are not CME clearing member firms. The daily reports provide these two self-regulatory organizations (SROs) with immediate information regarding the respective amounts held in these customer protected accounts and whether there are any meaningful differences between the amounts reported by the respective FCM as compared with the

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102. Press Release, U.S. Commodity Futures Trading Comm'n, CFTC Files Complaint Against Peregrine Financial Group, Inc. and Russell R. Wasendorf, Sr. Alleging Fraud, Misappropriation of Customer Funds, Violation of Customer Fund Segregation Laws, and Making False Statements (July 10, 2012), http://www.cftc.gov/PressRoom/PressReleases/pr6300-12.

103. BERKELEY RESEARCH GROUP, LLC, REPORT OF INVESTIGATION: ANALYSIS OF THE NATIONAL FUTURES ASSOCIATION'S AUDITS OF PEREGRINE FINANCIAL GROUP, INC. (Jan. 29, 2013), https://www.nfa.futures.org/news/BRG/report_of_investigation.pdf.

104. *Id.* at 9, 17-24.

105. *NFA Financial Requirement*, *supra* note 55.

106. *Id.*

107. *Id.*

amounts held directly by all of the FCM's selected depositories on behalf of the FCM. By receiving these amounts each day, the SROs can now easily determine whether any significant differences exist. This rule was needed following the bankruptcy of Peregrine Financial Group where the CEO of that FCM deliberately falsified the amounts being held at the depository.[108] Now, the depository itself must send reports each day to the SROs that reflect the amounts held by the depository.

The third major regulatory change, one that gets little attention but which, in my opinion, provides the most customer protections, is the new CFTC rule that requires all FCMs to deposit its customer margin requirements with the respective clearinghouse on a gross margin basis.[109] Prior to this rule change, each U.S. futures exchange required customer margins to be deposited with the clearinghouse on either a net or gross margin clearing basis. If the respective futures exchange applied a net margin clearing model, then more customer margins would be held directly by the FCM and less would be held at the clearinghouse. For example, assume ABC FCM has two customers. Customer X is long 100 June T-Bond futures contracts and Customer Y is short 100 June T-Bond futures contracts. Further assume that the initial margin requirement for these T-Bond futures contracts is $2,000 per contract. Thus, both Customer X and Customer Y would deposit $200,000 in initial margin with ABC FCM. However, if the exchange uses a net clearing model, then none of the $400,000 is forwarded to the clearinghouse by ABC FCM as the two customers have a net zero open position between their respective T-Bond futures positions. Thus, ABC FCM would hold all $400,000 in its Customer Segregated Account and could invest the $400,000 in accordance with the eligible investments permitted by CFTC Rule 1.25.[110] More importantly, ABC FCM directly controls the $400,000. In a gross clearing model, the entire $400,000 would be forwarded to the clearinghouse and held in a customer segregated account in the name of the respective clearing house. However, we have learned from the bankruptcy of MF Global that there was a shortfall of approximately $1.2 billion in its customer segregated account. At the time, the net clearing model applied. As noted above, whenever there is such a shortfall, all futures customers are treated on a *pro rata* basis, meaning that these futures customers are subject to "fellow customer risk." By requiring the full margin amount to be held at the clearing house, as is now required, this reduces the potential that there will be any such shortfall. This gross margin rule will provide more customer protections than those experienced by the industry as a result of the various FCM bankruptcies noted above. The net clearing margin model is still the prominent clearing model outside the United States.

108. See Part VI above.

109. Final Rule, Derivatives Clearing Obligations General Provisions and Core Principles, 76 Fed. Reg. 69,334 (Nov. 8, 2011) (to be codified at 17 C.F.R. pts. 1, 21, 39, and 40).

110. 17 C.F.R. § 1.25.

VIII. BEST PRACTICES FOR ENERGY TRADING FIRMS

In selecting a clearing firm, the energy trading firm may want to consider some if not all of the following best practices that apply to both U.S. and U.K financial firms.[111]

- Obtain a large amount of financial information about the financial firm. This may require the firm to provide a copy of its monthly financial statement (audited or unaudited) for the past three months and for the same three-month period of a prior year. U.S. FCMs are also now required to provide a lot more financial information on its website. The energy firm should also receive a copy of the firm's audited annual financial statement for the past two years. Financial firms are required to prepare such audited annual financial statements and file them with their respective regulator within 90 days after their respective fiscal year end date. Request the financial firm to notify you in writing if its most recent financial net worth has declined by a certain percentage, let's say 10%.
- Obtain information from the financial firm about the initial margin requirements of its twenty largest futures customers (that is, their margin amounts but not their names), what derivative products these customers trade in through the firm, etc. This information is not publicly known but the energy firm can sign a Non-Disclosure Agreement with the FCM in an attempt to receive this information. The energy firm may also want to request trade data (e.g., trading volume) about the firm's customers, which clear the same futures and OTC derivatives traded by the energy firm. The energy firm can also request information about the market share in these products that are cleared by the firm on a gross or net basis. One of the greatest possible risks that may lead to a failed financial firm is a dramatic volatile change in the price of the derivative product on a one, two or three day basis. If the respective firm holds a very large market share by some or all of its customers, and the markets experience a standard deviation move much greater than normal, such as what occurred on October 19, 1987 when the Dow Jones declined by 22% in one day, there is just a greater possibility that such an unusually large market move could adversely impact that FCM.
- Open a futures and OTC cleared swap account with multiple firms in each country and keep open positions at each respective FCM. The energy firm needs these multiple accounts to be able to transfer immediately open positions from the failing firm to the other firm. Without an account at a different firm, it will be literally impossible to open a new account at another firm within a day or two. Therefore, without having this second or third account, the prompt transfer of open positions will be difficult to achieve. When Lehman Brothers filed for bankruptcy in September 2008, futures customers which had futures clearing accounts at other FCMs could easily

111. *See* Commodity Exchange Act §§ 1 et al.

transfer their open futures positions and underlying cash or equity to another FCM. Those that did not were able to transfer their open positions and cash to Barclays Capital but this transfer is not always guaranteed. The trustee in bankruptcy could easily just liquidate the open positions and then wait to transfer the cash after finalizing its report which can take several months to complete.

- If the energy trading firm is using derivatives on a bona fide hedging basis, always complete and sign a Hedge Letter and check the required provisions in the Hedge Letter that instructs the Trustee in Bankruptcy not to liquidate its open positions. This protection is set forth in CFTC Part 190, but the customer must complete and sign this Hedge Letter for each account that it has opened at the FCM. Thus, if the energy trading firm has multiple accounts opened at the FCM, let's say one account is for crude oil futures and one for natural gas futures, the Hedge Letter must be completed for both accounts. I would also ask for confirmation from the FCM that it has received the Hedge Letter and that the underlying accounts are marked as hedge accounts at the FCM. This special provision protecting energy firms that are using derivatives to hedge their exposures does not apply in the United Kingdom.
- Request information about what litigation currently exists or was recently completed that directly involves the firm and its operations, in particular, which could result in large financial damages. I do not mean every customer arbitration as that information is on the FINRA website but you can request such civil litigation that involves allegations requesting a certain large amount. You may also want to know what material actions have been taken against that firm by the: NFA, FINRA, the SEC, and CFTC in the United States and the FCA in the United Kingdom. Obviously, any pending business conduct/enforcement action may not be provided by the firm, but the energy firm can still request to receive information on these litigation matters.
- Request information on changes in senior management at the firm that have taken place in the past three years and get bios or other information about the current senior management team and any future replacements. In addition, you should obtain a complete directory of all key people at the firm so the energy firm can be contacted by them. In the United States, the energy firm can go to the NFA website (www.nfa.futures.org) and click on the BASIC link at the top of the NFA website. The energy firm can then look up each of these key people at the FCM to find out whether any charges have ever been filed against any of them. This information remains on the NFA website well after the person leaves the industry.
- Request a list of 10 or more referrals from existing and past customers at each firm and the contact information of key people at these clients. Once again, you can sign a Non-Disclosure Agreement or another letter agreement if the financial firm requires such a document.

IX. CONCLUSION

While both the U.S. and the U.K. regulatory regimes are quite comparable and most, if not all, of the larger financial firms have their principal offices in both New York and London, there are still differences and thus different customer protections between these two countries. Therefore, each energy firm must consider all of the applicable laws, regulations and practices that exist in each country as noted above. However, there is one major difference between the United States and the United Kingdom that, in my opinion, distinguishes the two countries. The major difference is the U.S. Bankruptcy Code, a law providing for the special liquidation of a stock brokerage firm (e.g., a BD) and of a commodity brokerage firm (e.g., a FCM). This U.S. law is unique. It may then be preferable for an energy firm to open its account with a U.S. financial firm and attempt, if it is at all possible, to keep most of its assets maintained within the United States even if this requires financing for non-U.S. transactions.

Moreover, notwithstanding today's financial markets and all of the recent legislative and regulatory changes taking place globally regarding the derivatives industry, there are still concerns for energy trading firms as to how and with whom to trade derivatives. However, I strongly believe the derivatives markets provide much better protections today than ever before. While many of these new laws and regulations have been quite costly to comply with and many are still confusing, the derivatives industry is in a better position today. A better world does require the global regulators to refine many regulations that have been adopted since the 2008 financial crisis and make sure all future regulations are effective as to their main purpose. Regulatory inefficiency is worse at times than having no regulations. It is also important that regulators have actual industry knowledge and experience so that all regulations provide their requisite efficiency.

An energy trading firm must also evaluate the financial firms that they will trade derivatives through and compare the laws and regulations in each country where the financial firm is located or where the derivative product is traded or cleared. It also needs to establish the requisite internal reports and policies in an attempt to minimize, to the extent possible, that the financial firm it chooses to do business with will not file for bankruptcy.