

CFTC PROPOSES REFORMS TO BANKRUPTCY RULES FOR FUTURES BROKERS AND CLEARINGHOUSES

On April 14, 2020, the Commodity Futures Trading Commission ("CFTC" or "Commission") proposed amendments (the "Proposed Rule") to part 190 of its regulations, which governs bankruptcy proceedings for commodity brokers such as futures commission merchants ("FCMs") and derivatives clearing organizations ("DCOs"). The Proposed Rule represents the first comprehensive revision of Part 190 since it was finalized in 1983.

Major themes in changes to part 190 under the Proposed Rule include the following:

Protection of Customer Assets

1. Customer Priority. The Proposed Rule includes changes to implement the following concepts in the insolvency context: (i) shortfalls in customer property should be made up from the FCM's general assets, (ii) public customers should receive priority treatment relative to non-public customers, and (iii) public customers are entitled among themselves to a *pro rata* distribution of available assets based on their respective claims.

The proposal to include new definitions of "public customer" and "non-public customer" does not materially change the Commission's approach to indirect clearing positions held by FCMs on behalf of the FCM's foreign affiliates' customers, although if adopted, the new regulations are likely to require amendments to opinions relating to the status of property held by the FCM under indirect clearing arrangements.

2. Transfer of Positions. The Proposed Rule includes changes to foster the policy preference for transferring positions of public customers and associated collateral to a solvent FCM instead of liquidating such positions.

These changes, if adopted, are likely to obviate the elections that an FCM's customer is presently required to make in its futures and cleared swap account documents for the liquidation or transfer of its open positions in the event of the insolvency of the FCM.

Clarification of Insolvency Regulations

3. Clarification and Explanation of Part 190. The Proposed Rule adds a new § 190.00, which is designed to set out the statutory authority, organization, core concepts, scope, and rules of construction for part 190 in order to enhance market participants' understanding of the commodity broker insolvency regime.
4. Enhanced Insolvency Trustee Discretion. In order to foster the insolvency trustee's ability to effectively manage a commodity broker insolvency, certain changes would enhance the trustee's discretion generally as well as in several specific areas.
 - a. *Aggregate Treatment of Customers.* Recent commodity broker bankruptcies have involved many thousands of customers, with as many as hundreds of thousands of commodity contracts. In light of the difficulty of treating large numbers of customers on a bespoke basis, the Proposed Rule would permit the trustee to treat them in the aggregate. These changes reflect a shift from a model in which the trustee receives and complies with instructions from individual customers to a model where the trustee transfers as many open commodity contracts as possible.
 - b. *Prioritizing Cost Effectiveness and Promptness Over Precision.* On a related note, the Commission proposes that it is more important for a trustee to be cost effective and prompt in the distribution of customer property than it is to value each customer's entitlements on an individual basis. Because calculations of each customer's funded balance should be "as accurate as reasonably practicable under the circumstances, including the reliability and availability of information," the trustee may avoid more precise calculations where such precision would not be cost effective or could not reasonably be accomplished on a prompt basis (for example, in a situation where price information for particular assets or contracts at particular times was not readily available).
5. SIPA and OLA. The Proposed Rule notes the applicability of part 190 in the context of (i) proceedings under the Securities Investor Protection Act ("**SIPA**") in the case of insolvent FCMs subject to a SIPA proceeding, and (ii) proceedings under the orderly liquidation authority provisions of Title II of the Dodd-Frank Act ("**OLA**") in the case of a commodity broker insolvency where the Federal Deposit Insurance Corporation ("**FDIC**") acts as a receiver. The proposed text about SIPA reflects the fact that many FCMs are also registered broker-dealers. In several recent insolvencies of firms that were both broker-dealers and FCMs, the trustee was appointed under SIPA rather than the FCM rules.
6. Letters of Credit as Collateral. The Commission proposes changes to the treatment of letters of credit as collateral in order to ensure that, consistent with the *pro rata* distribution principle, customers that post letters of credit as collateral suffer the same proportional loss as customers that post other types of collateral. Essentially the proposal treats the undrawn portion of a

letter of credit as a distribution to the relevant customer, forming part of its *pro rata* distribution.

7. Clearing Organization Insolvency. The Proposed Rule adds a new subpart C to part 190 to govern the insolvency of a DCO. Although a clearing organization bankruptcy has never occurred, the Commission proposes to establish the approach to be taken in addressing such a bankruptcy in order to foster prompt action in the event such a bankruptcy occurs, and in order to establish a clear counterfactual (i.e., “what would creditors receive in bankruptcy liquidation?”) in the event of a resolution of a clearing organization pursuant to OLA.

The Commission’s approach toward a DCO bankruptcy is characterized by three overarching concepts:

- i. the trustee should follow, to the extent practicable and appropriate, the DCO’s pre-existing default management rules and procedures and recovery and wind-down plans that have been submitted to the Commission;
- ii. assets intended to flow through to clearing 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. other provisions would draw from provisions applicable to FCMs.

Updates to Reflect Regulatory Changes, Technological Developments and Actual Practice

8. Regulatory Changes and Actual Practice. Many changes are meant to update part 190 in light of changes to the regulatory framework over the past three decades. Some of these codify actual practice in prior bankruptcies, such as a requirement that an FCM notify the Commission of its imminent intention to file for voluntary bankruptcy. In another case, the Commission is addressing for the first time the interaction between part 190 and recent revisions to the Commission’s customer protection rules.
9. Technological Developments. Other changes follow from technological developments, including changes from paper-based to electronic means of communication (e.g., the use of email and websites for the trustee to communicate with customers on a regular basis). The proposal would also recognize the change from paper-based to electronic recording of “documents of title.” Several of these changes also reflect the actual practice in prior bankruptcies.

Many of the changes in the Proposed Rule are meant to clarify existing regulations, without any intent to change substantive results. Some of these changes will address ambiguities that have complicated past bankruptcies, while others are intended to avoid potential ambiguities and circumstances that have not yet arisen.

The deadline to provide comments on the Proposed Rule is July 13, 2020.

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