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Contractual Framework for Cleared Derivatives: The Master Netting Agreement Between a Clearing Customer Bank and a Central Counterparty

*Byungkwon Lim and Aaron J. Levy**

In this article, the authors discuss the legal characterization of derivatives contracts that are centrally cleared under U.S. laws. The focus is on the treatment of both exchange-traded and centrally cleared over-the-counter derivatives of a bank that is not a clearing member of a central counterparty.

The recent financial crisis revealed vulnerabilities in, among other areas, the global over-the-counter (“OTC”) derivatives markets. As noted in a Congressional Research Service report,¹ the OTC derivatives market is dominated by a limited number of “highly interconnected” dealers that “are highly exposed to spillover, or contagion, effects from turmoil in other parts of the markets,” potentially triggering “a chain of credit-related losses and defaults.” For this reason, a “basic theme in derivatives reform proposals is to get the OTC market to act more like the exchange-traded futures market—in particular, to have bilateral OTC swaps cleared by a third-party clearing organization.”²

To address the vulnerabilities revealed by the financial crisis, the Group of Twenty (“G20”) leaders agreed in September 2009 to establish a reform agenda

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¹ Jackson and Miller, “Comparing G-20 Reform of the Over-the-Counter Derivatives Market,” *Congressional Research Service Report for Congress* (Feb. 19, 2013). A report by the International Organization of Securities Commissions stressed that regulators in the relevant jurisdictions should seek to ensure, among other things, that “all standardised derivatives should be cleared through central counterparties.” See “Requirements for Mandatory Clearing,” Technical Committee of the International Organization of Securities Commissions (Feb. 2012).

² Two years earlier, the Financial Crisis Inquiry Commission, established in 2009 as part of the Fraud Enforcement and Recovery Act to examine the U.S. financial crisis, concluded in its final report that the “sweeping deregulation” of OTC derivatives played a key role in amplifying and spreading losses resulting from the collapse of the housing bubble through a lack of transparency and inadequate capital and margin requirements for such transactions. See *The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States*, Financial Crisis Inquiry Commission (Jan. 2011).

for the global OTC derivatives markets through a number of global initiatives, including the requirement that all standardized OTC derivatives should be cleared through central counterparties (“CCPs”). In the United States, Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) implements the G20 commitment by requiring the clearing of certain OTC swaps and security-based swaps,³ as determined by the Commodity Futures Trading Commission (the “CFTC”) and the Securities and Exchange Commission (the “SEC”).⁴

Central clearing of bilateral contracts has a long history,⁵ but the legal analysis of central clearing has been at best sporadic and frequently inaccurate. It has taken on greater practical significance in the post-crisis environment as the regulatory treatment of derivatives contracts often varies depending on the legal characterization of the contracts.

This article discusses the legal characterization of derivatives contracts that

³ For swaps, *see* Section 2(h)(1)(A) of the Commodity Exchange Act (the “CEA”). For security-based swaps, *see* Section 3C of the Securities Exchange Act of 1934 (the “Exchange Act”).

⁴ At the time of this article’s publication, four categories of interest rate swaps and two categories of credit default swaps are subject to mandatory clearing in the United States, while no security-based swaps are currently subject to mandatory clearing.

⁵ The social benefits of central clearing have been extensively discussed. They include multilateral netting, increased transparency, centralized collateral management and daily margining. (*See, e.g.*, Cecchetti, Gyntelberg and Hollanders, “Central counterparties for over-the-counter derivatives,” *BIS Quarterly Review* (September 2009). *See also* Nosal, “Clearing over-the-counter derivatives,” *Economic Perspectives*, Federal Reserve Bank of Chicago, Fourth Quarter 2011). In a highly stressed environment, central clearing has proven effective in mitigating, to a great extent, the contagion and spillover effects of a large bank failure. (*See, e.g.*, The Depository Trust & Clearing Corporation Annual Report 2008). In addition, by producing information insensitive securities or contracts, central clearing eliminates the need for market participants to obtain and verify information about other participants. (*See, e.g.*, Carapella and Mills, *Information insensitive securities: the benefits of Central Counterparties*, Federal Reserve Board of Governors (Oct. 17, 2012)). It may largely eliminate counterparty risk externalities resulting from excessive leveraging by one or more market participants. (*See, e.g.*, Acharya and Bisin, “Counterparty Risk Externality: Centralized Versus Over-the-Counter Markets,” *Journal of Economic Theory* 149 (2014)). Central clearing is not a panacea and raises a significant systemic risk because of the concentration of a very large number of trades and resulting risk in a handful of CCPs. For example, the recent financial crisis demonstrated that the fire sale of collateral posted for swaps and other financial contracts that benefit from a safe harbor from the automatic stay under the Bankruptcy Code may pose a serious systemic risk to the financial system. Concentrating a vast amount of collateral at a handful of CCPs may exacerbate this fire sale risk. (*See, e.g.*, Antinolfi, et. al., “Repos, Fire Sales, and Bankruptcy Policy,” *Federal Reserve Bank of Chicago* (Nov. 30, 2012)).

are centrally cleared under U.S. laws. It will focus on the treatment of both exchange-traded and centrally cleared OTC derivatives of a bank that is not a clearing member of a CCP. While the universe of transactions classified as OTC derivatives varies from country to country, the central clearing requirement of the Dodd-Frank Act applies to “swaps” and “security-based swaps.”⁶ Since, at the time of this article’s publication, the regulations and interpretive guidance governing the central clearing of swaps have already been finalized and mandatory central clearing has commenced with respect to certain types of swaps, this article focuses on cleared swaps.

CENTRAL CLEARING OF DERIVATIVES

Overview of Clearing

The life cycle of a derivatives contract is comprised of a series of steps leading up to its final settlement—namely, execution, clearing and settlement. A collateralized swap contract may also involve a custodial arrangement. Similarly, the life cycle of a futures contract is comprised of execution, clearing, custody and settlement.

The term “clearing” generally refers to a series of activities following the execution of a contract until settlement (whether by physical delivery or cash payment), and includes trade capture, matching, confirmation, position netting, payment/delivery amount calculation, and notification to the parties (including a settlement bank and clearing agency) for settlement. For swaps and futures, which create an ongoing contractual relationship between the counterparties, clearing involves significantly more activities, such as trade management, collateral and risk management, and delivery/payment management.

In the case of bilateral uncleared swaps, the parties to a swap compare the terms of the contract and are responsible for clearing (and managing the clearing process). In the case of futures and cleared swaps, the relevant CCP is responsible for every facet of clearing once the futures or cleared swap contract is executed between the parties. In the United States, a CCP interposes itself

⁶ For the definition of “swap,” see CEA Section 1a(47) and Section 1.3(xxx) of the CFTC regulations. For the definition of “security-based swap,” see Section 3(a)(68) of the Exchange Act and Section 240.3a(68) of the SEC regulations. Swaps are regulated by the CFTC, security-based swaps are regulated by the SEC and certain other derivatives (i.e., mixed swaps) are jointly regulated by both agencies. CFTC and SEC, Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48208 (August 13, 2012).

between the two parties to a futures or swap contract⁷ by way of novation. Novation generally means “the act of substituting for an old obligation a new one that either replaces an existing obligation with a new obligation or replaces an original party with a new party.”⁸

In the United States, all futures transactions must be (1) executed on a futures exchange⁹ (except in certain limited situations, such as exchange of futures for physical transactions)¹⁰ and (2) cleared through a CCP registered with the CFTC as a “derivatives clearing organization.”¹¹ Until the enactment of the Dodd-Frank Act, U.S. laws did not require that swaps be traded on exchanges or other execution facilities or be cleared through CCPs. In the post-Dodd-Frank world, a large portion of OTC derivatives subject to U.S. laws will ultimately be cleared through a CCP.¹²

U.S. Clearing Model for Futures

Futures contracts are executed on the trading floor or through the electronic market of the exchange where they are listed, and are immediately cleared. Most large futures exchanges (such as the Chicago Mercantile Exchange (“CME”) and the Intercontinental Exchange (“ICE”)) clear their own listed futures through a CCP that is a division or affiliate of the exchange. Other exchanges, such as the CBOE Futures Exchange, which do not operate their own CCPs,

⁷ A central clearing system might be designed and function in such a manner as to keep the original contract between the original parties. For example, a clearinghouse could simply provide clearing services (margin management, settlement management, data reporting and default management). In that case, the clearinghouse would merely act as a facilitator of clearing. Absent a performance guarantee by the clearinghouse, the parties would bear each other’s credit risk throughout the term of the relevant contract. Alternatively, a clearinghouse may provide a performance guaranty in addition to clearing services, as is done by Canada’s Natural Gas Exchange Inc. (“NGX”), which clears natural gas forward and futures contracts directly between the two original parties. Finally, a clearinghouse may become a central counterparty (a CCP), as in the U.S. derivatives clearing system.

⁸ *Black’s Law Dictionary* (9th ed. 2009).

⁹ In the United States, these futures exchanges must be registered with the CFTC as “designated contract markets.” See CEA Section 4(a)(1).

¹⁰ See Section 1.38 of the CFTC regulations.

¹¹ See CEA Section 5(d)(11)(A) and Section 38.601 of the CFTC regulations.

¹² Even if the clearing requirement is fully implemented in the United States, a significant portion of such OTC derivatives transactions will not be cleared. For example, the Dodd-Frank Act provides an exemption from the clearing requirement for OTC derivatives of non-financial entity end-users used for hedging or risk mitigation purposes. In addition, complex or bespoke derivatives will not be clearable simply because no CCP is willing to accept them for clearing (and thereby expose itself to financial risks that are difficult to manage).

designate an unaffiliated CCP to clear trades executed on their exchange.¹³

The execution function is typically performed by executing brokers, which must be members of the exchange, and the clearing function is performed by a CCP and clearing brokers, which must be approved as clearing members of the CCP.¹⁴ A customer gives its order to an execution broker and the execution broker sends the customer's order to the exchange for execution. An executing broker is required to register with the CFTC as an "introducing broker" ("IB") or "futures commission merchant" ("FCM").¹⁵

Once an order is matched by the exchange and the trade is executed, each side of the trade is directed to a designated clearing member FCM, each of which then submits the trade to the CCP. A party to a futures contract that is not itself a clearing member of the CCP must enter into a clearing agreement with a clearing member registered with the CFTC as an FCM.¹⁶ Under such clearing agreement, the FCM agrees to submit the customer's futures trades for clearing and the customer agrees to be bound by the rules of the CCP. The FCM enters into a set of agreements with the CCP and agrees to be bound by the rules of the CCP. The FCM guarantees its customers' obligations to the CCP and is thus fully liable to the CCP for the performance of its customers' obligations regardless of whether the customer performs. However, the FCM does not guarantee the performance of the CCP to the customer.

Once a trade is submitted by the FCM to a CCP, the CCP compares the terms of the two orders and confirms the trade to the FCMs, which in turn confirm the trade to their customers. Once the trade has been affirmed by the FCMs to the CCP, the contract between the original counterparties is discharged, and the CCP, through the process of novation, becomes the counterparty to each side of the trade under two new contracts (one with each of the original trading counterparties). The FCM acts as an agent on behalf of

¹³ The CBOE Futures Exchange, for instance, designates the Options Clearing Corporation as the CCP for futures transactions executed on the exchange.

¹⁴ Executing brokers may be, but often are not, clearing members. Thus, the clearing firm for a particular customer may be different from its executing broker.

¹⁵ See CEA Section 4d. An IB is not permitted to hold any customer assets. Therefore, where a customer places an order for a futures trade with an IB, the IB must give up such customer trade to an FCM which will collect margin from the customer and hold all assets of the customer. An FCM is permitted to place an order for a customer. A member of an exchange that does not execute futures trades for a customer is not required to register as an IB or FCM with the CFTC.

¹⁶ See CEA Section 4d. Since only FCMs are permitted to hold customer assets, clearing members that clear futures for customers through a CCP must be FCMs. However, not all FCMs are clearing members of a CCP. Therefore, an FCM that is not a clearing member of a CCP must give up a customer futures trade to a clearing member FCM for clearing through the CCP.

its customers, intermediating the futures contract between its customer and the CCP.

A customer must deposit initial margin with its FCM in connection with their futures trades and the FCM must, in turn, post margin with the CCP in respect of its customers' positions. All futures positions are marked to market on at least a daily basis. At the end of each trading day, the CCP will calculate the aggregate net variation margin amount for all customers of an FCM. The CCP will either issue a margin call to the FCM for additional margin in respect of its customers' positions or will credit the FCM with margin gains in respect of its customers' positions. The FCM will then issue a margin call to customers with a net loss that reduces the value of such customer's initial margin below a specified level and will credit the account of any customer with a net gain on its positions. FCMs are obligated to make margin payments to the CCP irrespective of whether the FCM's customers honor their obligations to make margin payments to the FCM.

A clearing member FCM carries an omnibus account at a CCP for its futures clearing customers¹⁷ and the CCP is required to hold the futures customer assets in such an omnibus account separate from the proprietary accounts of any FCM and from the assets of the CCP itself.¹⁸ While an FCM itself must maintain an account for its customers' funds separate from its own funds and must treat the funds of each futures customer as belonging to such customer,¹⁹ the FCM is not required to separately identify each customer to the CCP and the CCP is not required to maintain separate subaccounts within the FCM's omnibus customer account at the CCP for each customer of the FCM. Therefore, the CCP is not required to hold the initial margin of a particular customer in a segregated account for that customer, separate from the initial margin of other customers or allocated specifically to such customer. In other words, the assets of all futures customers who clear through an FCM are treated as the assets of a single customer for this purpose.²⁰

¹⁷ An FCM maintains two accounts for futures—a house account for its proprietary trades and an omnibus customer account for all customer trades.

¹⁸ CFTC regulations Section 1.20(g).

¹⁹ See CFTC regulations Sections 1.20(a) and (g).

²⁰ Therefore, in the case of futures clearing under U.S. law, each clearing customer of an FCM is subject to “fellow customer risk”—*i.e.*, the risk that a CCP will need to access the customer collateral of non-defaulting customers to cure an FCM default. More specifically, “fellow customer risk” refers to the risk that a clearing customer sustains a loss on a futures contract and defaults on a margin call from its FCM and the loss exceeds the sum of the FCM's available liquid assets, the collateral posted by the defaulting customer and any additional

U.S. Clearing Model for Swaps

The U.S. swap clearing model is essentially based on the futures clearing model. Under the U.S. clearing framework for customer swaps, as with futures, a clearing member registered with the CFTC as an FCM submits swaps on behalf of its non-clearing member customers.²¹ As with futures, upon submission of the contract to the CCP for clearing, the contract is novated, the CCP becomes the counterparty to each side of the trade under two new contracts and the FCM acts as an agent on behalf of its customers, intermediating the clearing of the swap between its customer and the CCP. The FCM enters into a set of agreements with its customers and, separately, with the CCP, under which the FCM and each of its customers agree to be bound by the rules of the CCP. The FCM guarantees²² its customers' obligations to the CCP and is thus fully liable to the CCP for the performance of its customers' obligations regardless of whether the customer performs. Finally, as with futures, the FCM is not required to guarantee the performance of the CCP to the FCM's customers.

There are some notable differences, however, between the futures and swaps clearing models. In the case of cleared swaps, unlike futures, the FCM will identify the relevant customer to the CCP by providing either the customer's name (and other identifying information) or its legal entity identifier ("LEI") or global markets entity identifier ("GMEI") when the FCM submits a swap to the CCP on behalf of the customer for clearing. As discussed below, this is necessary for the FCM and the CCP to comply with the CFTC's rules on the protection of cleared swap customer property (referred to as the "legally segregated operationally commingled" ("LSOC") rules). The LSOC rules permit the collateral of all cleared swap customers of an FCM to be held together pre-bankruptcy in a single "omnibus" account (*i.e.*, operational commingling),

payments immediately available from the defaulting customer. In such a situation, the FCM will default on its obligation to the CCP (*i.e.*, a double default). Under the futures clearing model, in the event of a double default, a CCP may access the customer collateral of the FCM's customer account to meet a loss in that account, regardless of whether the customer that posted that collateral is in default.

²¹ An FCM directly submits its own and its affiliates' proprietary swaps to a CCP for clearing and segregates such swaps from its customers' swaps.

²² The CFTC's final rules on protection of cleared swap customer collateral provide that "in economic effect, . . . the clearing FCM serves as a guarantor of its customers' swaps obligations to the [CCP]." *See Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions*, 77 Fed. Reg. 6336, 6337 (Feb. 7, 2012). The CFTC later reiterates in the same release that "the FCM functions as a guarantor of customer transactions with a [CCP]." *See Id.*, at 6341.

but require FCMs and CCPs (1) to keep books and records separately reflecting the collateral held for each customer and (2) to refrain from using the initial margin of one customer to satisfy obligations of another customer or the FCM's own obligations on its proprietary trades (*i.e.*, legal segregation).

Under the rules of a CCP, a clearing member FCM maintains an omnibus customer account at a CCP for clearing customer swaps.²³ The CCP maintains on its books a subaccount for each customer of an FCM within the FCM's omnibus customer account, and each subaccount is identified by a customer identification number or other identifying information in order to comply with the LSOC rules. As is the case for futures, swaps clearing customers must deposit initial margin with their FCM in connection with their swaps and the FCM must, in turn, post margin with the CCP in respect of its customers' positions. These positions are marked to market on at least a daily basis. In compliance with the LSOC rules, the initial margin for a customer trade will be recorded by the CCP in the relevant subaccount for such customer within the FCM's omnibus customer account. The initial margin posted by the FCM for all of its customer swaps may either be held by the CCP or deposited by the CCP in a customer margin account at one or more "permitted depositories"²⁴ (separate from any house account for the FCM). Therefore, the initial margin of each customer is legally segregated from (but may be operationally commingled with) the initial margin for other customers' swaps and is legally and operationally segregated from the initial margin for the FCM's proprietary swaps.

During each variation margin settlement cycle, the CCP will calculate the aggregate net variation margin amount for each customer with respect to all cleared swaps and determine the net variation margin the CCP will have to pay to or collect from an FCM for all customers of the FCM. At the end of each settlement cycle,²⁵ the CCP will either issue a margin call to the FCM for an

²³ As is the case for futures, an FCM maintains two accounts for cleared swaps—a house account for its proprietary trades and an omnibus customer account for all customer trades.

²⁴ See CFTC regulation Sections 22.3 (providing that a CCP may deposit cleared swap customer collateral at a "permitted depository, rather than holding such collateral itself) and 22.4 (defining the term "permitted depository" to include banks and trust companies located in the United States and registered derivatives clearing organizations).

²⁵ For CCPs that clear multiple types of swaps, a customer's net variation margin amounts will be calculated separately for each product class (also referred to as a "silo"), each of which may include one or more product types, such as interest rate swaps, credit default swaps, foreign exchange swaps, various types of futures, options on futures, commodities, bonds and equities. For instance, CME has one class for interest rate swaps (and futures and swaps that are commingled with interest rate swaps, based on reliably correlated price risks), another for credit

aggregate net margin amount in respect of all of its customers' positions or will credit the FCM with an aggregate net margin gain in respect of all of its customers' positions.²⁶ The FCM will then pay or collect the variation margin amount from each of its customers by either crediting the account of any customer with a net gain on its positions or issuing a margin call to customers with a net loss. The FCM is obligated to make margin payments to the CCP irrespective of whether its customers perform their obligation to post margin to the FCM, but the FCM does not guarantee the CCP's obligations to its customers.²⁷

BASEL STANDARDS AND U.S. RULES ON CLEARING CUSTOMER BANKS' DERIVATIVE EXPOSURES

Introduction

In July 2013, the Board of Governors of the Federal Reserve System (the "FRB"), the Office of the Comptroller of the Currency (the "OCC"), and the

default swaps and a third class (the "Base Product Class") for all other products cleared at CME. Each class has its own guaranty fund and financial safeguards package, as well as its own default management procedures, including "limited recourse" provisions stating that, upon an FCM default, a non-defaulting FCM (and, ultimately, its clearing customers) suffering losses in connection with the CCP's clearing operations for a particular product class will have recourse only to the collateral, guaranty funds and other funds relating to that class and will have no claim to any collateral or funds relating to any other class. In the event of a default by one or more FCMs, any loss to CME resulting from such FCM default(s) will be covered only by the collateral posted by FCMs in the relevant product class and the guaranty fund for, and any additional assessments on FCMs clearing swaps in, such product class.

²⁶ The CFTC's regulations permit, but do not obligate, a CCP to net variation margin across an FCM's cleared swap customers. Even following an FCM default, the CFTC regulations continue to permit, but do not obligate, such variation margin netting. If a CCP elects to net variation margin following an FCM default, the first resource that the CCP should use to offset variation margin losses is the collateral attributable to the defaulting FCM's customers whose positions have generated variation margin losses during the relevant cycle, and only once that collateral is depleted should the CCP offset any remaining losses (on a pro rata basis) against any variation margin gains of the defaulting FCM's other customers. To the extent that a customer's variation margin gains are used to offset the losses of other customers, a customer with such gains retains a claim against the defaulting FCM's estate for the amount of gains it did not receive. CFTC Letter No. 12-31, "Staff Interpretation Regarding Part 22" (November 1, 2012).

²⁷ In the case of cleared swaps, unlike futures, clearing members are required to pay, or are entitled to receive, "price alignment interest" ("PAI") to or from the CCP. PAI refers to interest paid on the cumulative variation margin received for cleared swaps. The payment of PAI for cleared swaps supports the view that margin payments for cleared swaps are appropriately characterized as collateral payments, as opposed to settlement payments, as in the case of futures variation margin payments.

Department of the Treasury (“Treasury”) adopted final rules²⁸ (the “Basel III Capital Rules”) setting forth a revised regulatory capital framework for U.S. banking organizations based on the Basel Committee on Banking Supervision’s (“BCBS”) “Basel III: a global regulatory framework for more resilient banks and banking systems” (“Basel III Framework”).²⁹ The Basel III Capital Rules include a new framework³⁰ for determining the regulatory capital requirement for exposures to the credit risk of a CCP for cleared derivatives contracts.³¹

²⁸ FRB and OCC final rule, *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. 62018 (Oct. 11, 2013).

Federal Deposit Insurance Corporation (“FDIC”) interim final rule, *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. 55340 (Sep. 10, 2013).

²⁹ *Basel III: A global regulatory framework for more resilient banks and banking systems* (Dec. 2010, rev. June 2011)). The BCBS later published interim requirements (effective through the end of 2016) and final requirements (effective thereafter) providing detailed rules for the capitalization of banks’ exposures to CCPs. The term “Basel III Framework,” when used in this article, refers to all of these standards.

³⁰ Prior to the Basel III Framework, neither Basel standards nor U.S. bank capital rules provided a capital requirement for a bank’s credit exposure to a CCP for cleared transactions. Banks did not hold capital for exposure to the credit risk of a CCP, and clearing member banks took the position that they were not required to hold capital with respect to their default fund contributions.

³¹ As the Basel Committee on Banking Supervision was finalizing the Basel III Framework and U.S. banking regulators were working on revised capital rules for banks’ exposures to CCPs, some observed that “[i]f large parts of the OTC derivatives markets are to be smoothly transferred to central clearing, market participants will need realistic economic incentives.” They identified a risk that “these incentives will either be insufficient or even negative,” and noted that this risk is “most notable in the Basel proposals for capitalisation of exposures to clearinghouse default funds, and capital rules for ‘client-clearer’ banks.” They cautioned that without adequate incentives, “the outcome of OTC clearing will not be more central OTC clearing, but a mix of damage to liquidity, slow or no expansion of central clearing to new products, and a shift from standardised, more regulated products to non-standardised products or jurisdictions where OTC clearing is not mandatory.” See Quarry, Wilkinson, Pittaway and Cheah, *OTC Derivatives Clearing: Perspectives on the Regulatory Landscape and Considerations for Policymakers*, Oliver Wyman (May 31, 2012). While this holds true where central clearing is optional and is irrelevant where central clearing is mandated, it suggests that at least some swap market participants may attempt to avoid central clearing as much as possible by, for example, structuring a swap in a manner that may not be accepted by a CCP for clearing. Such swap market participants may perceive the cost of central clearing (particularly the cost of maintaining cash and other liquid

Under the Basel III Capital Rules, the capital treatment of a bank's exposure to a CCP depends on, among other factors, whether the bank's cleared derivatives are subject to a "qualifying master netting agreement" (a "QMNA"). Where cleared derivatives contracts are subject to a QMNA, the trade exposure amounts with respect to such contracts are calculated on a net basis, yielding more favorable capital treatment than would be available where the transactions are not subject to a QMNA.

The Basel III Framework and the Basel III Capital Rules provide other incentives for banks to centrally clear OTC derivatives. For example, in recognizing the credit risk mitigation impact of collateral, a bank that uses the collateral haircut approach must adjust the haircuts upward by using a 20-business day margin period of risk ("MPOR") rather than a five-business day MPOR if a "netting set" (as defined below) with a counterparty includes more than 5,000 trades at any time during a quarter or includes one or more complex trades that are hard to replace or trades involving illiquid collateral.³² This rule does not apply with respect to centrally cleared derivatives. As another example, in determining a bank's capital requirements for counterparty credit risk with respect to OTC derivatives, a bank is generally required to incorporate "credit value adjustments" (*i.e.*, capital charges to reflect counterparty credit risk), but the bank is not required to do so where its counterparty is a CCP.³³

Cleared Derivatives Exposure for Risk-Weighted Assets Ratio

Under the Basel III Capital Rules, when calculating risk-weighted asset amounts for cleared derivatives, a banking organization that is a clearing customer (a "clearing customer bank") must first multiply the "trade exposure amount" for the cleared derivative by the appropriate risk weight. The risk weight for the trade exposure amount of a cleared derivative between a clearing customer bank and a CCP that is a "qualified" CCP ("QCCP")³⁴ is either two

collateral at a CCP) as less than optimal from their perspective without taking into account the externalities that may result from uncleared swaps.

³² See Section 132(d)(5)(iii) of the Basel III Capital Rules and Section II.A.3 of *Basel III: A global regulatory framework for more resilient banks and banking systems* (Dec. 2010, rev. June 2011).

³³ See Section II.A.1 of *Basel III: A global regulatory framework for more resilient banks and banking systems* (Dec. 2010, rev. June 2011).

³⁴ This article pertains only to CCPs located in the United States, all of which consider themselves to be QCCPs. (See "QCCP Status of LCH.Clearnet Limited ('LTD'), LCH.Clearnet SA ('SA') and LCH.Clearnet LLC ('LLC') (Jan. 13, 2014)"; see also "FAQ: CME Inc. QCCP Status and Standing in Europe"). A QCCP is a CCP that, among other things, is in sound financial condition (as determined by the relevant banking agency), is subject to supervision by the FRB, the CFTC, the SEC, or a foreign supervisory authority in the CCP's home country,

percent or four percent depending on whether certain conditions are met. The appropriate risk weight is two percent where (1) the collateral posted by the clearing customer bank to the QCCP or FCM is subject to an arrangement that prevents any losses to the clearing customer bank due to the joint default or concurrent insolvency of the FCM and any other customers of the FCM and (2) the clearing customer bank has conducted sufficient legal review (and maintains sufficient written documentation of such review) to conclude with a well-founded basis that in the event of a legal challenge (including one resulting from an event of default or insolvency proceeding), the relevant court or administrative authorities would find the arrangements to be enforceable under the law of the relevant jurisdictions.³⁵ If either of these conditions is not satisfied, the appropriate risk weight is four percent.

For a clearing customer bank, the trade exposure amount for a cleared derivative or a “netting set” of cleared derivatives is the sum of (1) the exposure amount for the cleared derivative or netting set, calculated using the same methodology used to calculate the exposure amount for OTC derivative contracts (*i.e.*, either the “current exposure methodology” or the “internal models methodology”),³⁶ and (2) the fair value of the collateral posted by such clearing customer (other than collateral that is held by a custodian in a manner that is “bankruptcy remote” from the CCP, the FCM, other counterparties of the FCM and the custodian itself). (A “netting set” is a group of transactions with a single counterparty that are subject to either a “qualifying master netting agreement”³⁷ or a “qualifying cross-product master netting agreement.”)³⁸

requires all parties to contracts cleared by the CCP to be fully collateralized on a daily basis and meets certain risk-management standards.

³⁵ These risk weights are the same as those set forth in the Basel III Framework.

³⁶ While all banks will be required, beginning on January 1, 2015, to use a modified version of the current exposure methodology to calculate the exposure amount for a netting set of cleared derivatives under the “standardized approach” (and must follow the Basel I based rules until then), “advanced approaches banking organizations” (*i.e.*, those with consolidated assets greater than \$250 billion or consolidated on-balance sheet foreign exposures of at least \$10 billion) must also calculate that exposure using the internal models methodology (since they are required to calculate their risk-based capital ratios under both approaches and to use the lower, and more conservative, of the two ratios in determining their compliance with the minimum ratios).

³⁷ Even for a group of transactions between a bank and a single counterparty subject to such a master netting agreement, if the bank is using the “internal models methodology” to calculate the corresponding exposure and identifies specific “wrong-way risk” for any transaction in the group, the bank must treat any such transaction as its own netting set (separate from the netting set composed of the other transactions) and must exclude it from the model. The Basel III Capital Rules define “wrong-way risk” as the risk that arises when an exposure to a particular counterparty is positively correlated with the probability of default of that counterparty.

Collateral is held in a manner that is “bankruptcy remote” from an entity when it would be excluded from such entity’s estate in a receivership, insolvency or similar proceeding.

Under the Basel III Capital Rules, multiple OTC derivative transactions with a single counterparty that are subject to a QMNA constitute a netting set, and the exposure amount is equal to the sum of the net current credit exposure amounts and the adjusted sum of the potential future exposure (“PFE”) amounts of all such OTC derivative transactions. The net current credit exposure is the greater of zero or the net sum of all positive and negative mark-to-fair values of the individual OTC derivative contracts. In other words, where a banking organization enters into multiple OTC derivative transactions with a single counterparty under a QMNA, the current credit exposure amount for all such transactions is calculated on a net basis.

In addition, the aggregate PFE amount for multiple OTC derivative transactions subject to a QMNA is calculated under a formula that yields an exposure amount lower than the amount that would apply absent a QMNA. The PFE amount for a single OTC derivative contract is equal to the product of the notional principal amount of the contract multiplied by the relevant conversion factor specified for such contract under the Basel III Capital Rules. The adjusted sum of the PFE amounts for all OTC derivatives contracts subject to a QMNA is the sum of (1) 0.4 multiplied by A_{Gross} and (2) 0.6 multiplied by NGR multiplied by A_{Gross} , where “ A_{Gross} ” represents the gross PFE for such contracts (*i.e.*, the sum of the PFE amounts for each individual contract) and “NGR” represents the “net-to-gross ratio” (*i.e.*, the ratio of the net current credit exposure to the gross current credit exposure, where the gross exposure equals the sum of the positive current credit exposures of all individual contracts subject to the QMNA). The presence of a QMNA, therefore, yields a lower aggregate PFE amount for all contracts covered by the QMNA since that amount is directly correlated with the “net-to-gross” ratio, which decreases as a function of the net current credit exposure amount for such contracts.³⁹

³⁸ A “qualifying cross-product master netting agreement” is a QMNA that provides for termination and close-out netting across multiple types of financial transactions or QMNAs in the event of a counterparty’s default, where the underlying transactions include more than one of the following: an OTC derivative, eligible margin loan or repo-style transaction. The netting benefit from cross-product netting in reliance on a qualifying cross-product master netting agreement is permitted only when calculating the counterparty credit exposure amount from derivatives under the internal models methodology.

³⁹ In March 2014, the BCBS published a final standard that provides a new methodology for a bank to calculate its counterparty credit risk exposure arising from derivatives contracts. The new methodology (the “standardised approach (SA-CCR) for measuring exposure at default for

For OTC derivative transactions that are not subject to a QMNA, on the other hand, both the current credit exposure amount and the potential future exposure amount are calculated separately for each such transaction (*i.e.* on a gross basis), yielding a trade exposure amount for all derivatives transactions with a particular counterparty that may be substantially greater than the amount that would apply were the transactions subject to a QMNA.

Qualifying Master Netting Agreement

The Basel III Capital Rules define a “qualifying master netting agreement” as a “written, legally enforceable agreement” that satisfies certain requirements. First, it must create a single legal obligation for all individual transactions covered by the agreement upon an event of default, including upon a counterparty’s insolvency. In addition, it must provide the bank with the right to accelerate, terminate and close-out on a net basis all transactions under the agreement and to liquidate or set-off collateral promptly upon an event of default, including upon a counterparty’s insolvency, and the exercise of such rights must not be stayed or avoided under applicable law, subject to certain exceptions for receivership or resolution under the Federal Deposit Insurance Act, Title II of the Dodd-Frank Act, or any similar insolvency law applicable to government-sponsored entities.

The Basel III Capital Rules further provide that, to recognize an agreement as a QMNA, a bank must conduct sufficient legal review to conclude with a well-founded basis that: (1) the agreement satisfies the netting and setoff requirement described above and (2) in the event of a legal challenge (including one resulting from default or insolvency), the relevant court and authorities would find the agreement enforceable under applicable law. Depending on the circumstances, this condition may require either a formal legal opinion or a less formal analysis, whether by in-house counsel or an outside law firm.⁴⁰

Therefore, a bank must determine that its cleared derivatives are subject to a QMNA in order to avail itself of reduced exposure amounts in determining its capital requirements for its cleared derivatives.

Cleared Derivatives Exposure for Leverage Ratio

A master netting agreement also provides benefits to banks in calculating

counterparty credit risk”) will replace the current exposure method and will become effective on January 1, 2017. BCBS, *The standardised approach for measuring counterparty credit risk exposures* (March 2014, rev. Apr. 2014). If the U.S. banking agencies adopt the SA-CCR in the future, a bank would generally be permitted to calculate the counterparty credit exposure from derivatives on a net basis with respect to derivatives subject to a QMNA.

⁴⁰ See adopting release for Basel III Capital Rules, 78 Fed. Reg. at 62096.

their “leverage ratio” under a new BCBS standard⁴¹ (the “Basel III Leverage Ratio Standard”) and in calculating their “supplementary leverage ratio” under the Basel III Capital Rules and the U.S. rules based on that standard (the “Supplementary Leverage Ratio Rules”).⁴²

The Basel III Leverage Ratio Standard modified the existing BCBS standards (set forth in the Basel III Framework) for calculating a bank’s derivatives exposure in measuring its “leverage ratio.” While the new framework generally requires banks to calculate their derivative exposures as the “replacement cost” for the current exposure plus the potential future exposure of the derivative, the replacement cost for a set of derivatives covered by an eligible bilateral netting contract is calculated on a net basis and the add-on is based on the same formula used for calculating the aggregate PFE amount of OTC derivative transactions subject to a QMNA under the Basel III Capital Rules (*i.e.*, $0.4(A_{Gross}) + 0.6(NGR)(A_{Gross})$). To qualify for this treatment, the netting agreement must satisfy certain conditions similar to the QMNA definition under the Basel III Capital Rules.

The Basel III Capital Rules follow effectively the same approach in calculating an “advanced approaches” bank’s derivatives exposure for its supplementary leverage ratio. Under the Basel III Capital Rules, a bank’s leverage exposure for derivatives equals the sum of (1) the balance sheet carrying value of all of its derivatives (subject to certain deductions) and (2) the PFE amount for each of the bank’s derivatives (or each single-product netting set thereof). Since the Basel III Capital Rules clarify that derivatives exposures are calculated under GAAP, which permits netting of derivatives assets and liabilities on a bank’s balance sheet where the derivatives are subject to a “master netting agreement” (as described below), the balance sheet carrying value of a bank’s derivatives will include the bank’s current derivatives exposure on a net basis only if the derivatives are subject to a master netting agreement. Additionally, since the aggregate PFE amount for a netting set of derivatives transactions is calculated under the same formula set forth above only where the derivatives are subject to a QMNA, the presence of a QMNA will also yield a lower aggregate PFE amount. In sum, the presence of a master netting agreement reduces both components of the leverage exposure calculation under the Basel III Capital Rules.

In addition, under the Basel III Leverage Ratio Standard, cash variation

⁴¹ BCBS, *Basel III leverage ratio framework and disclosure requirements* (Jan. 2014).

⁴² OCC, FRB and FDIC, *Regulatory Capital Rules: Regulatory Capital, Revisions to the Supplementary Leverage Ratio* (Sept. 3, 2014).

margin exchanged between a bank and a CCP may be viewed as a form of pre-settlement payment (rather than a collateral payment),⁴³ such that the bank may use cash variation margin received (and the receivables assets from cash variation margin provided) to reduce the leverage ratio exposure measure, if the derivatives transactions and variation margin amounts are covered by a “single master netting agreement” between the CCP and the bank that provides for netting of the underlying transactions and certain other conditions are met.⁴⁴ In light of this modification to the Basel leverage ratio framework, the U.S. banking agencies revised their existing supplementary leverage ratio rules to make the U.S. rules consistent with the Basel III Leverage Ratio Standard. For instance, the Supplementary Leverage Ratio Rules permit a bank to use cash variation margin to reduce its derivatives exposure in measuring its supplementary leverage ratio if the relevant derivatives are subject to a QMNA (as defined in the Basel III Capital Rules) and other conditions similar to those in the Basel III Leverage Ratio Standard are met.⁴⁵

Net Derivative Cash Outflow Amount for Liquidity Coverage Ratio

A master netting agreement also provides benefits to banks in calculating their “liquidity coverage ratio” under the BCBS standard⁴⁶ (the “Basel III LCR Standard”) and the U.S. rules based on that standard (the “LCR Rules”).⁴⁷ Under both the Basel III LCR Standard and the LCR Rules, a bank’s liquidity coverage ratio is calculated by dividing its “high-quality liquid asset” (“HQLA”) amount (*i.e.*, the value of its stock of unencumbered, high-quality liquid assets

⁴³ See note 27 above regarding price alignment interest paid on cumulative variation margin received for cleared swaps.

⁴⁴ In order to use cash variation margin to reduce the leverage ratio exposure measure, the following conditions must be met: (1) the variation margin must be exchanged on a daily basis, (2) the cash variation margin received must be received in the same currency as the currency of settlement of the derivative contract and (3) the variation margin exchanged must be sufficient to fully extinguish the mark-to-market exposure of the derivative (subject to applicable threshold and minimum transfer amounts).

⁴⁵ While a bank’s supplementary leverage ratio under the Basel III Capital Rules is calculated using GAAP, which provides a bank the option to use cash collateral to reduce its derivatives exposure if the GAAP criteria for offsetting (discussed below) are satisfied (the “GAAP offset option”), the Supplementary Leverage Ratio Rules require a bank to reverse the effect of the GAAP offset option for purposes of determining its total leverage exposure unless the derivatives are subject to a QMNA and the cash collateral is cash variation margin that satisfies the same conditions set forth in the Basel III Leverage Ratio Standard.

⁴⁶ BCBS, *Basel III: International framework for liquidity risk measurement standards and monitoring* (Dec. 2010).

⁴⁷ OCC, FRB and FDIC, *Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards* (Sept. 3, 2014).

in stressed scenarios) by its “net cash outflow amount” over a specified period, where the net cash outflow amount equals the difference between expected cash outflows and expected cash inflows (capped at 75 percent of expected cash outflows) over a specified period. In determining a bank’s net cash outflow amount, inflows and outflows on derivatives contracts (*i.e.*, payments and collateral due to or from a counterparty during the relevant period) may be taken into account on a net basis only if such transactions are subject to a master netting agreement (which must constitute a QMNA under the LCR Rules).

Net Credit Exposure for OCC Lending Limit

A QMNA also provides benefits to national banks and federal and state-chartered savings associations subject to the OCC’s lending limits rules.⁴⁸ The Dodd-Frank Act revised the existing statutory limit on outstanding “loans and extensions of credit” by covered banks and savings associations to a single person that may be outstanding at one time, by providing that this measure includes any credit exposure to a person arising from a derivative transaction, among other transactions.⁴⁹ The OCC rules provide that, for banks and savings associations using an internal model to calculate their counterparty credit exposure on derivatives transactions, the credit exposure for derivatives, measured by adding the current credit exposure and the PFE amount for each transaction, may be calculated on a net basis for derivatives subject to a QMNA.

The OCC lending limits rules also permit banks and savings associations to calculate their credit exposures on derivatives transactions using either of two non-internal model methods—the “conversion factor matrix” method or the current exposure method. While the conversion factor matrix method fixes the credit exposure for derivatives at the PFE amount of each derivative and does not allow for netting regardless of whether the derivatives are subject to a QMNA, the current exposure method follows the current exposure method in

⁴⁸ For the final rules, see OCC, *Lending Limits*, 78 Fed. Reg. 37930 (June 25, 2013). For the interim final rules (which are still applicable, subject to certain modifications in the final rules), see OCC, *Lending Limits*, 77 Fed. Reg. 37265 (June 21, 2012).

⁴⁹ Section 5200 of the Revised Statutes provides that the total loans and extensions of credit by a national bank to a person outstanding at one time must not exceed 15 percent of the bank’s unimpaired capital and surplus for loans that are not fully secured, plus an additional 10 percent of unimpaired capital and surplus for fully secured loans. Section 5(u)(i) of the Home Owners’ Loan Act extends this requirement to both federal and state-chartered savings associations. Section 610 of the Dodd-Frank Act amends Section 5200 of the Revised Statutes to provide that the definition of “loans and extensions of credit” includes any credit exposure to a person arising from a derivative transaction, among other transactions.

the Basel III Capital Rules for determining the credit exposure amount of multiple OTC derivative contracts, which, as noted above, is calculated on a net basis for derivatives subject to a QMNA. Therefore, a QMNA provides benefits to banks and savings associations under the OCC's lending limits rules when an internal model method or the current exposure method is used to calculate derivatives exposures.

In addition, the presence of a QMNA may lessen other regulatory burdens, such as the limits on credit exposures to a single counterparty under Section 165(e) of the Dodd-Frank Act and the limits on credit exposures to an affiliate under Section 23A of the Federal Reserve Act (as applied to derivatives under Section 608 of the Dodd-Frank Act). While we do not address these other benefits of a QMNA in this article, we briefly discuss below U.S. financial accounting rules, which impose substantially the same requirements as the foregoing BCBS standards and U.S. bank capital and other rules in order for a bank to report cleared swaps on a net basis.

ACCOUNTING RULES FOR CLEARED DERIVATIVES

Under the U.S. financial accounting rules, a reporting party may report derivatives assets and liabilities on a net basis in its balance sheet if it enters into multiple derivatives contracts covered by a "master netting agreement" that provides the reporting party with a "right to setoff" amounts owed to and by the other party. Reporting parties are permitted under GAAP to present a net amount on their balance sheets for their derivatives assets and liabilities, subject to certain conditions.⁵⁰ Where the parties to multiple derivatives transactions intend to settle those transactions on a gross (rather than a net) basis, a "master netting agreement" is required in order for the reporting party to offset on its balance sheet the fair value of derivatives in a loss position against the fair value of derivatives in a gain position.

A general principle of accounting is that the offsetting of assets and liabilities on the balance sheet is improper except if a "right of setoff" exists.⁵¹ A right of setoff is a debtor's legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor. In other words, a debtor having

⁵⁰ See Sections 210-20 and 815-10 of GAAP (Accounting Standards of the Financial Accounting Standards Board).

⁵¹ This general principle requiring a "right of setoff" applies not only to unconditional receivables from and payables to another party, but also to certain conditional amounts to be received or paid in the future, where the amount to be received or paid under the contract depends on future interest rates, future exchange rates, future commodity prices, or other factors.

a valid right of setoff may offset the related asset and liability and report the net amount. A “right of setoff” exists when all of the following conditions are met:

- (1) each of two parties owes the other determinable amounts;
- (2) the reporting party has the right to set off the amount owed with the amount owed by the other party;
- (3) the reporting party intends to set off; and
- (4) the right of setoff is enforceable at law.

This general principle also applies to “derivative instruments,” which a reporting party is required to recognize as assets or liabilities in its balance sheet (measured at fair value). In order to present derivatives payables and receivables on a net basis under GAAP, the same requirements must be met such that a right of setoff exists.

While the requirement that the reporting party must intend to set off the relevant amounts (for settlement purposes) is satisfied where derivatives transactions are settled on a net basis pursuant to an ISDA Master Agreement or similar agreement, it is not satisfied where counterparties choose to settle their derivatives transactions on a gross basis. Nonetheless, even where a reporting party does not intend to actually settle its derivatives transactions on a net basis, it may, at its option,⁵² offset the fair value amounts recognized for such transactions (and the fair value amounts recognized for the right to reclaim or return cash collateral arising from such transactions) on its balance sheet, as long as the relevant transactions are executed with the same counterparty under a “master netting agreement.” A master netting arrangement exists if the reporting entity has multiple contracts, whether for the same type of derivative instrument or for different types of derivative instruments, with a single counterparty that are subject to a contractual agreement that provides for the net settlement of all contracts through a single payment in a single currency in the event of default on or termination of any one contract.

LEGAL CHARACTERIZATION OF CENTRALLY CLEARED DERIVATIVES

As discussed above, the capital treatment of a bank’s centrally cleared derivatives depends on whether such derivatives are subject to a QMNA. As the definitions of QMNA and master netting agreement are essentially the same, a bank’s cleared derivatives subject to a QMNA may be reported on its balance

⁵² A reporting entity must make an accounting policy decision as to whether to offset fair value amounts of derivatives and the entity’s choice to offset or not must be applied consistently.

sheet on a net basis, provided other GAAP requirements are satisfied. In this section, we discuss two critical steps in the QMNA analysis, which apply equally to the “master netting agreement” analysis in the financial reporting context.

Identifying the Parties to a Cleared Swap or Futures Contract

Background

The first step in the QMNA analysis is to identify the parties to a cleared derivatives contract. There are multiple parties involved in the execution, clearing and settlement of a clearing customer’s swap or futures contract. They are the original parties that execute a swap or futures contract (*i.e.*, the clearing customer and its original counterparty), one or two FCMs that clear the trade for the original parties, and the CCP.

Before a swap or futures contract is submitted for clearing, the original counterparties will execute the swap either bilaterally or on a designated contract market (“DCM”) or swap execution facility (“SEF”). One or more FCMs⁵³ then submit the trade to a CCP for clearing, whereupon the swap or futures contract between the original parties is immediately novated under the CFTC rules and the CCP rules, resulting in two separate contracts (mirroring one another), between the CCP and each of the original counterparties.⁵⁴

The original parties cease to transact with each other following novation. No payment will be exchanged, no margin will be transferred and no delivery will be made, between the original parties. Neither of the original parties will be concerned about the creditworthiness of the other party during the term of the swap or futures contract. In the case of a swap or futures contract executed anonymously on a DCM or SEF, a party to the original contract will not even know the identity of the other party with which it is executing the contract, and thus need not (and cannot) evaluate the credit of such party (particularly where

⁵³ Where both of the original counterparties are clearing customers, the swap will be submitted for clearing by either a single FCM on behalf of both customers or by two different FCMs (acting for one customer each). Where one of the original counterparties is a clearing customer and the other is a clearing member trading for its own account, the customer’s FCM (which may be the customer’s counterparty acting as an FCM) will submit the swap for clearing on behalf of its customer and the clearing member will submit the swap for clearing on its own behalf.

⁵⁴ See Cecchetti, Gyntelberg and Hollanders, “Central counterparties for over-the-counter derivatives,” *BIS Quarterly Review* (September 2009). (“In an OTC market with a CCP, trading itself continues to take place on a bilateral basis. Once a trade agreement is reached, however, it is transferred, or ‘novated’, to the CCP: the single contract between the two initial counterparties is replaced by two new contracts between the CCP and each of the two parties”).

the contract is cleared, such that the insolvency of such party will have no impact on the other party).⁵⁵ Therefore, the original parties are not the parties to a cleared swap or futures contract.

The next candidate that might theoretically be treated as a counterparty to a CCP on a customer's cleared swap or futures trade is the customer's clearing member FCM, since the FCM interacts with the CCP in administering cleared swaps and futures on behalf of its customers under a set of agreements with the CCP. Under such characterization, the contract between the FCM and the customer is either a back-to-back swap with terms mirroring those of the FCM's contract with the CCP or a similar agreement under which the FCM and the customer agree to make payments corresponding to the FCM's cleared swap or futures contract with the CCP. In our view, the FCM is not a party to a cleared swap or futures contract with the CCP based on the plain language of the rules and other authorities discussed below, as well as the economic and other features of derivatives clearing.

If an FCM were treated as the principal (rather than as an agent) on its customers' cleared swap or futures trades, the FCM would be required, in calculating its risk-weighted asset amounts, to take into account its exposure on both its trade with the CCP (treated as a cleared derivative exposure) and its back-to-back trade with its clearing customer (treated as an OTC derivative exposure), thereby subjecting the FCM to an additional capital charge for the cleared trade with the CCP that would not apply if the FCM is treated as an agent for its customers' cleared transactions.⁵⁶

In the next section, some instances in which courts and Congress have misconstrued novation and the contractual framework for cleared derivatives are discussed. Then, the article discusses certain CFTC and banking agency

⁵⁵ While the LSOC model in the U.S. swap clearing rules, unlike the futures clearing rules, is intended to prevent a possible mutualization of loss among multiple customers clearing through the same FCM, the very concept of clearing through a CCP hinges on the mutualization of losses resulting from defaults of one or more clearing customers or FCMs (or both, in the case of a "double default") at a level higher than the FCM, as the CCP operates on a finite amount of capital and default management resources. Parties to cleared swaps may ultimately suffer a loss by reason of a default of one or more other parties to cleared swaps even if central clearing has operated fully in accordance with all applicable rules. If a CCP itself becomes insolvent due, for instance, to massive losses from investments of initial margin or because a default by one clearing customer results in a default of its FCM and the default funds and other financial safeguards are not sufficient to preserve clearing services in the relevant product category, then all cleared swaps of the CCP or all cleared swaps in the relevant category may be terminated or torn up. In those cases, non-defaulting clearing customers may suffer losses.

⁵⁶ See adopting release for Basel III Capital Rules, 78 Fed. Reg., at 62099-62100.

rules, as well as the economic features of futures and cleared swaps, which confirm the clearing customer's status as a party to its cleared derivatives.

Past Misunderstandings of Contractual Framework for Cleared Derivatives

The process of novation has been misconstrued over the decades in a number of instances, including in court decisions relating to futures and in federal statutes. For instance, in one case, the Seventh Circuit's description of futures clearing includes the profoundly inaccurate statement that when a non-clearing member sells a futures contract to a third party, "the contract of sale is actually between the [seller's] clearing member . . . and the buyer's clearing member."⁵⁷

The Seventh Circuit is not alone in mistakenly suggesting that clearing results in a contract between multiple clearing members, as opposed to two separate contracts between the CCP and each of the original counterparties. In fact, Congress itself made the same error in enacting the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"). Section 404 of FDICIA provides for the closeout and netting of "covered contractual payment obligations and covered contractual payment entitlements of a member of a clearing organization to and from all other members of a clearing organization" in accordance with the terms of an applicable netting contract.

CFTC and Banking Agencies Rules

CFTC rulemakings implementing the Dodd-Frank Act unequivocally demonstrate that the CFTC views swaps clearing as operating under an agency model for customer contracts. The CFTC's final rules on "core principles" for derivatives clearing organizations ("DCOs") require that a DCO clearing swaps must have rules providing that, upon acceptance of a swap by the DCO for clearing, the original swap is extinguished and "is replaced by an equal and opposite swap between the [DCO] and each clearing member acting as principal for a house trade or acting as agent for a customer trade."⁵⁸

As initially proposed, this rule required that DCOs clearing swaps have rules providing that "[t]he original swap is replaced by equal and opposite swaps between clearing members and the [DCO]," without specifying that the clearing member acts as agent for a customer's cleared swap. In response to commenters' concerns that the proposed rule described novation in a manner that misleadingly "appears to presume the use of a 'principal' model for all

⁵⁷ *Bernstein v. Lind-Waldock & Co.*, 738 F.2d 179 (7th Cir. 1984). (The quoted statement was dicta and holds no precedential value).

⁵⁸ CFTC regulation Section 39.12(b)(6). A "derivatives clearing organization" (or DCO) is a term used in the CEA and the CFTC regulations to refer to a CCP.

cleared swaps, even those swaps cleared on behalf of customers,”⁵⁹ the CFTC modified this language in its final rule to clarify that, upon submission of a swap for clearing, “[t]he original swap is replaced by an equal and opposite swap between the [DCO] and each clearing member . . . acting as agent for a customer trade.” This clarification in the final rules demonstrates that both the CFTC and the FCM industry agree that an FCM acts as an agent for its customers in clearing the customers’ swaps.

Additionally, in reporting cleared swaps data to a swap data repository (for both OTC and exchange-traded swaps that are cleared), as required by the CFTC’s swap data reporting rules,⁶⁰ DCOs (*i.e.*, CCPs) include the LEI or GMEI of the clearing customer as a party to the trade, in addition to the FCM’s information.⁶¹ This further reinforces the view that the clearing customer, rather than its FCM, is in practice regarded as a party to a cleared swap.

Finally, the Supplementary Leverage Ratio Rules confirm that the U.S. banking agencies also view a cleared derivatives transaction of a clearing customer bank as a contract between the clearing customer bank and the CCP in which the customer’s FCM acts only as an agent, guaranteeing its customer’s obligations to the CCP. In explaining that this rule requires clearing member banks to include this guaranteed amount (*i.e.*, the amount of the customer’s obligations to the CCP) in their total leverage exposure, the U.S. banking regulators noted in the release accompanying the proposed supplementary leverage ratio rules that “[t]here are two models for client-cleared transactions—the agency model, which is common in the United States, and the principal

⁵⁹ This comment was submitted to the CFTC by the Futures Industry Association (“FIA”) and two U.S. CCPs clearing swaps, CME and ICE. CME also commented that “at CME, an FCM clearing customer business acts as an agent for undisclosed principals (*i.e.*, the FCM’s customers) vis-à-vis CME and guarantees its customers’ performance” on their cleared transactions, and that “in order to preserve the agency model for customer-cleared swaps,” the CFTC should revise its proposed rules to clarify this. Additionally, FIA commented that “the proposed rule would conflict with the FCM’s position that, with respect to customer positions, FCMs are acting as agent, and not as principal, for customers in executing and clearing swaps (and futures) on behalf of customers,” and suggested that the proposed rule be revised to confirm that, in clearing customer swaps, an FCM “shall be deemed a guarantor and agent of a cleared swap and not a principal.” The CFTC made the clarifying modification requested by these commenters, thereby demonstrating that it agrees that FCMs act as agents in the swaps clearing context. *See Derivatives Clearing Organization Provisions and Core Principles*, 76 Fed. Reg. 69334, 69361 (Nov. 8, 2011).

⁶⁰ CFTC regulation Section 45.3(a) and (b).

⁶¹ This has been confirmed by the Depository Trust & Clearing Corporation, which operates DTCC Data Repository (U.S.) LLC, a CFTC-registered swap data repository.

model,”⁶² and that “[i]n the agency model, a clearing member client enters into a derivative transaction directly with the CCP.”⁶³

Economic Benefits and Risks

It is possible to view a clearing member FCM as a party to a cleared swap or futures contract with the CCP because the FCM guarantees the performance of the customer to the CCP and, as a result, the FCM bears the downside risk. The primary problem with this argument is that the FCM assumes the risk of non-performance by the customer of its swap or futures obligations without receiving any economic benefits from the swap or futures contract. In addition, all other benefits associated with central clearing accrue to clearing customers,⁶⁴ rather than their FCMs.

The FCM's guaranty is a necessary component of the U.S. clearing system. Since a CCP in the United States itself becomes a party to all futures and swaps it clears, it must manage various risks associated with such futures and swaps. One of such risk management tool is to restrict access by imposing financial and other requirements on those who choose to become direct participants in the clearing process of the CCP. An FCM that clears trades for customers must meet a number of financial and other requirements imposed by the CFTC and the relevant CCP.⁶⁵ Therefore, only a small number of FCMs interact with a CCP with respect to customer swaps and futures and a CCP naturally looks solely to such FCMs (and demands that such FCMs assume responsibility) for full performance of cleared swaps and futures, whether customer or proprietary trades.

⁶² Clearing in the United Kingdom and certain other European countries operates under a principal-to-principal model in which clearing results in back-to-back contracts, between the clearing member and the CCP, on the one hand, and between the clearing member and each of its customers, on the other.

⁶³ See OCC, FRB and FDIC, *Regulatory Capital Rules: Regulatory Capital, Proposed Revisions to the Supplementary Leverage Ratio*, 79 Fed. Reg. 24576 (May 1, 2014).

⁶⁴ See note 5 above discussing various benefits of central clearing.

⁶⁵ For instance, CME requires each clearing member clearing swaps to maintain a membership deposit at CME of at least \$5,000,000 and a guaranty fund deposit of \$50,000,000 for each relevant product category (or the clearing member's proportionate share of the two largest clearing member's losses for the relevant product category). Clearing members are also subject to a minimum capital requirement equal to the greater of (1) \$50,000,000, (2) the relevant CFTC or SEC capital requirement or (3) 20 percent of the aggregate initial margin requirement for CME-cleared credit default swaps and interest rate swaps for customer and house accounts. (For bank clearing members, capital is calculated pursuant to the rules and regulations of the clearing member's primary banking regulator). FCMs are also subject to financial requirements of the CFTC and the National Futures Association, including a minimum "adjusted net capital" requirement.

In other words, an FCM must screen its potential customers that lack direct access to the CCP and must access the CCP through the FCM. Otherwise, the CCP would have to screen all persons that want to access its clearing services, which would be an unworkable requirement. In addition, an FCM is in the best position to screen, monitor and manage the credit and other risks any such clearing customer may pose to the CCP. Thus, the mere fact that an FCM guarantees its customers' swaps or futures does not render the FCM a party to such transactions; rather, this guaranty is a logical consequence of the FCM's decision to permit its customers to access the CCP's clearing services through the FCM. Conversely, the fact that an FCM does not provide a guarantee to its customers of the CCP's performance is consistent with our view that CCPs' risk management concerns are the impetus for requiring that FCMs guarantee their customers' obligations.

In the case of a cleared swap, each original party in essence agrees to replace the original bilateral swap with a swap with the CCP. In doing so, each original party gives up its direct right to and interest in collateral that would otherwise be posted by the other party in exchange for the CCP's management of swap payments and collateral transfers (and thus of the counterparty credit risk) arising from the cleared swap and the other benefits associated with central clearing.⁶⁶ In other words, the collateralized bilateral swap is exchanged for the uncollateralized swap with the CCP, which assumes the responsibility for trade and collateral management for its own account to fulfill its credit intermediation function.⁶⁷

We have examined above the general characteristics of central clearing for futures and swaps under U.S. law. As noted above, however, clearing mechanics

⁶⁶ As discussed above, the Basel III Framework and the U.S. Basel III Rules assign a very low risk weight to cleared swaps if specified conditions are met. In light of such low risk weight assigned to cleared swaps, it will become very important to ensure that CCPs are properly regulated and managed. In order to assign this lower risk weight to a bank's exposure to a CCP, the CCP must be regulated and managed in accordance with the requirements set forth in the QCCP definition in Section 2 of the Basel III Capital Rules. *See also Principles for Financial Market Infrastructures*, Committee on Payment and Settlement Systems (Bank for International Settlements) and Technical Committee of the International Organization of Securities Commissions (Apr. 2012).

⁶⁷ In addition to this credit intermediation function, a CCP provides other benefits to clearing customers, such as reporting swap data to a central depository (*see* Sections 45.3(a)(2) and 45.4(b) of the CFTC regulations) and turning bilateral swaps into information insensitive contracts. *See* Carapella and Mills, *Information insensitive securities: the benefits of Central Counterparties*, Federal Reserve Board of Governors (Oct. 17, 2012); *see also* Tucker, "Are Clearing Houses the New Central Banks," *Over-the-Counter Derivatives Symposium*, Chicago (Apr. 11, 2014).

differ between futures and swaps under the Commodity Exchange Act (the “CEA”) and the CFTC regulations. In the case of cleared swaps, unlike futures, the FCM will identify the relevant customer to the CCP by providing either the customer’s name or its LEI or GMEI to the CCP. Additionally, while in the futures context, the collateral of all clearing customers of an FCM is accounted for on an omnibus basis, in the swaps context, each customer’s collateral is legally segregated from the collateral of the FCM’s other customers using subaccounts within an FCM’s omnibus customer account. Next, we consider whether these differences in the clearing structure and mechanics of swaps and futures impact our conclusion regarding the existence of an enforceable contract between a clearing customer and a CCP in both contexts.

Enforceability of Cleared Swaps and Futures Contract

No case law yet exists regarding cleared swaps, and the existing futures case law does not directly address either the identity of the counterparties or the enforceability of a futures contract. However, longstanding agency law principles establish that the customer, as a party to a cleared swaps or futures contract, may enforce that contract against a CCP in both contexts.

In the futures context, courts⁶⁸ have referred to a clearing member FCM as an “agent” for its customer⁶⁹ and have held that a futures clearing customer has standing to sue a CCP⁷⁰ (while an FCM sustaining losses due to its guaranty obligation does not).⁷¹ In *Klein & Co. Futures, Inc. v. Board of Trade of the City of New York*,⁷² the Second Circuit held that an FCM lacked standing to maintain a private action under the CEA against its clearing customer’s principal or the CCP. The case involved an appeal of the District Court’s dismissal, based on lack of standing, of an FCM’s federal law claims (under the CEA) against the Board of Trade of the City of New York, a CCP, the principal of the FCM’s customer and others. The FCM sued to recover losses resulting from its obligation to satisfy a margin call following a default by its customer. Stressing that the FCM did not trade or own the contracts in question, and did not have any financial interest in the customer’s account (since the losses resulted from the customer’s inability to cover its margin call), the Second Circuit upheld the District Court’s holding that the FCM lacked standing to

⁶⁸ This article focuses on New York case law.

⁶⁹ See *Peltz v. SHB Commodities, Inc.*, 115 F.3d 1082 (2d. Cir. 1997); see also *Klein*, 464 F.3d 255, 260 (2d Cir. 2006) (*cert. dismissed*, 552 U.S. 1085 (2007)).

⁷⁰ See *Leist*, 638 F.2d 283 (2d Cir. 1980) (*aff’d, sub nom Merrill Lynch*, 456 U.S. 353 (1982)).

⁷¹ See *Klein*, 464 F.3d 255.

⁷² *Id.*

maintain a private action under the CEA against its clearing customer's principal or the CCP (even though the FCM was responsible for making or receiving margin payments from a CCP).

The Second Circuit emphasized that the FCM plaintiff “functioned merely as a broker or agent that earned commissions for handling its customer[s]’ trades.”⁷³ Rejecting the FCM’s argument that it faced investment risk relating to changes in the value of its customers’ commodity contracts (a risk that the FCM contended was “identical to that taken by any purchaser or seller of commodity contracts who is granted standing under the CEA”), the Second Circuit stressed that “regardless of whether [the customer’s] trading position rose or declined in value, [the FCM] had no interest in any of the resulting profits or investment losses” and suffered damages only because of its customer’s inability to cover a margin call—“a credit loss, not a trading loss.”⁷⁴ We note that while the Second Circuit grounded its decision in *Klein* on the fact that the FCM did not purchase, sell or own the contracts in question and functioned merely as an agent, the case focused on whether an FCM has a statutory right of action (under the CEA) against its customer or a CCP, rather than whether a clearing customer has a contractual right of action against a CCP.

While the existing case law does not directly address this question with respect to a futures contract, the view that a clearing customer is the party to a cleared swap or futures contract is supported by longstanding agency law principles established in a number of cases involving various types of contracts. It is well established⁷⁵ that where an agent for a fully disclosed or a “partially

⁷³ *Klein*, 464 F.3d at 260. The CFTC argued in an amicus brief supporting the FCM’s appeal of the Second Circuit’s decision in *Klein* (the “CFTC Amicus Brief”) that the futures clearing model for customer trades involves back-to-back contracts between the customer and the FCM and between the FCM and the CCP. See Brief for the United States as Amicus Curiae Supporting Petitioner, *Klein & Co. Futures Inc. v. Board of Trade of the City of New York*, 2006 U.S. Briefs 1265; 2007 U.S. S. Ct. Briefs LEXIS 451 (Sup. Ct.) (July 19, 2007). However, the U.S. Supreme Court declined to grant *certiorari* in that case, allowing the Second Circuit’s decision to stand. The CFTC Amicus Brief pertained to futures; as applied to cleared swaps, the view expressed in the brief is inconsistent with the CFTC’s final rules on DCO core principles, which clarify that an FCM acts as an agent for its customers in clearing swaps. (See note 59 above). These rules were adopted several years after the CFTC Amicus Brief was submitted in *Klein*.

⁷⁴ *Klein*, 464 F.3d at 261-262.

⁷⁵ See, e.g., *Castro v. Federal Ins. Co.*, 823 F.Supp. 132, 134 (S.D.N.Y. 1993); *Zatto v. Great Neck Water Pollution Control District*, 798 N.Y.S.2d 714 (N.Y. Sup. Ct. 2004) (citing the Restatement (Second) of Agency § 292 (1958) (“The other party to a contract made by an agent for a disclosed or partially disclosed principal, acting within its authority, apparent authority or other agency power, is liable to the principal as if he had contracted directly with the principal, unless the principal is excluded as a party by the form or terms of the contract.”); *Van Damme*

disclosed” (or “unidentified”) principal, acting within its authority, enters into a contract with a third party, the principal is a party to the contract and the third party “is liable to the principal as if he had contracted directly with the principal, unless the principal is excluded as a party by the form or terms of the contract.”⁷⁶ (A principal is “partially disclosed” or “unidentified” when the third party has notice that the agent is acting on behalf of a principal but does not have notice of the principal’s identity. This is distinct from an “undisclosed” principal, which exists where a third party has no notice that the agent is acting on behalf of a principal.)⁷⁷

In the futures context, since the CCP knows only that the FCM is submitting a futures trade for clearing on behalf of a customer but does not know the identity of the particular customer for any given trade, the FCM is acting as agent for a “partially disclosed” or “unidentified” principal, to which the CCP is directly liable.⁷⁸ In the case of cleared swaps, since an FCM provides

v. Gelber, Nahum & Gasiunasen Gallery of Palm Beach, Inc., 856 N.Y.S.2d 503 (N.Y. Sup. Ct. 2008) (citing the Restatement (Third) of Agency § 6.02 (2006) (“When an agent acting with actual or apparent authority makes a contract on behalf of an unidentified principal, . . . the principal and the third party are parties to the contract”).

⁷⁶ Restatement (Second) of Agency § 292 (1958). *See also* Restatement (Second) of Agency § 293 (1958) (“The other party to a contract made by an agent on behalf of a disclosed or partially disclosed principal does not become liable to such principal upon it in an action at law if the principal is excluded as a party by the form or terms of the contract.” This concept is illustrated in the commentary to § 293 by a hypothetical provision in a written memorandum stating that “the contract is made solely between [the agent (A)] and [a third party (T)] and that [the principal (P)] is not a party to the contract.” In that case, P would have no cause of action against T. The commentary also provides: “In the absence of special circumstances, an agent does not have implied authority to make contracts upon which the principal cannot bring an action at law. Ordinarily, therefore, a contract excluding the principal as a party is unauthorized and the other party has notice of this, thereby becoming subject to liability for any interference with the principal’s affairs caused by the transaction.” Therefore, unless the principal specifically authorizes its agent to exclude it from the contract made by the agent with a third party, the third party will be liable to the principal absent special circumstances.)

⁷⁷ Restatement (Third) of Agency § 1.04 (2006).

⁷⁸ The contractual analysis becomes less clear where the agent enters into a contract with a third party on behalf of multiple unidentified (potential) principals. In one case, the District Court for the Southern District of New York held that multiple unidentified principals are bound by the terms of the contract that was entered into by an agent acting on their behalf with a third party once those principals were chosen to perform on the contract (since those previously unidentified principals became fully disclosed principals upon being chosen to perform). The court did not address the issue of whether such unidentified principals may enforce their rights under the contract (once chosen to perform the contract). *See Hidrocarburos y. Derivados, C.A. v. Lemos*, 453 F. Supp. 160, 172 (S.D.N.Y. 1977). But the Hidrocarburos scenario is not analogous to the swaps or futures clearing models. For cleared swaps, each principal is fully

a CCP with the name and/or LEI/GMEI⁷⁹ of a customer when submitting a cleared swap to the CCP for such customer for the first time, a cleared swap customer is a fully identified principal.

As a third party is fully liable to both a disclosed and a partially disclosed principal, the distinction between these two categories is irrelevant for purposes of determining whether a clearing customer may enforce a cleared swaps or futures contract against a CCP. However, as noted above, several features specific to swaps clearing indicate that the argument that a clearing customer may enforce a cleared derivative contract against a CCP is even stronger in the swaps context than in the futures context. Among other features, the swaps clearing model, unlike the futures model, requires segregation of each individual customer's "cleared swaps customer collateral" (as defined in section 22.1 of the CFTC regulations) from that of other customers (thereby eliminating "fellow customer risk") and direct interaction between the CCP and a defaulted FCM's customers.⁸⁰

FURTHER CONSIDERATIONS

It has been demonstrated that a clearing customer is a party to futures and cleared swap contracts with a CCP and has a right under applicable state law to enforce that contract against the CCP. Under the Basel III Capital Rules and other U.S. and international regulations and standards, other requirements

identified. For futures, an FCM clears a number of different contracts on behalf of its customers, such that a particular contract cleared by the FCM on behalf of a single customer involves only one unidentified principal. While all customer assets are held by the CCP in a single segregated account for the FCM, no other customer whose assets are held in such account has any beneficial ownership interest in that particular contract. Therefore, at least with respect to each futures contract cleared by the FCM for one customer, the customer is entitled to exercise its right under the contract. (While an FCM may clear a single futures contract on behalf of multiple principals (e.g., where a single futures contract is cleared on behalf of a joint account owned by multiple customers that are jointly and severally liable for the contract), this article does not address that scenario.)

⁷⁹ Since the CCP may use a customer's LEI or GMEI to easily identify the customer without any cost or expense, the disclosure by an FCM to a CCP of a customer's LEI or GMEI constitutes full disclosure of such customer's identity (even if the FCM does not disclose the customer's name). See *Getty Oil Co. v. Norse Management Co. (PTE)*, 711 F.Supp. 175 (S.D.N.Y. 1989) (holding that, even though the name of the principal was not disclosed on the contract, a third party had sufficient information available to it that put it on notice, and principal was deemed to have been disclosed).

⁸⁰ A number of CCP rules provide for direct settlement of any net obligations between the CCP and a customer of a defaulted FCM. See, e.g., LCH.Clearnet LLC Rule 204(c), CME Rules 802.G.2 and 802.G.4.

must be met in order for a clearing customer to avail itself of favorable capital and other treatment for cleared derivatives.

The next step in the QMNA analysis is to demonstrate that the relevant contract between a clearing customer and a CCP provides the customer with an enforceable right to net and set off all payment obligations between itself and a CCP upon the occurrence of a CCP event of default, and that the exercise of such right will not be stayed or avoided under applicable law, including the U.S. Bankruptcy Code, Part 190 of the CFTC Regulations and other federal insolvency regimes (subject to limited exceptions for certain types of receivership or resolution). This requires not only a careful consideration of the relevant agreements and CCP rules, but also a comprehensive analysis of a number of potentially applicable insolvency regimes.

While such an analysis is worthy of another article, those requirements are satisfied with respect to cleared futures and swaps under the U.S. rules. In addition, a number of other issues must be considered, such as clearing of derivatives contracts through a CCP using multiple FCMs, the appropriate insolvency regime for resolving an insolvent CCP, the proper application of so-called "anti-cherry picking" provisions in Title II of the Dodd-Frank Act to the porting of cleared derivatives between CCPs, and the interaction of the CCP insolvency regime (and the CCP rules governing CCP defaults) with the CCP default management rules for FCM defaults.

CONCLUSION

Clearing of derivatives through a CCP operates in a vastly different manner from the way bilateral (uncleared) derivatives are cleared between two market participants. Access to a U.S. CCP is restricted to qualified clearing members for the CCP's risk management purposes, and those clearing members that clear derivatives for their customers must satisfy further requirements under the CFTC regulations, including registration as an FCM. This clearing structure would be extremely difficult, if not impossible, to efficiently operate absent the FCMs' role in screening and monitoring the creditworthiness of its clearing customers and guaranteeing the performance of such customers to the CCP.

The U.S. derivatives clearing structure presents a unique legal relationship among a CCP, an FCM and the FCM's clearing customer. As we have demonstrated, however, this legal relationship may be analyzed under long-standing contract and agency laws to establish that a cleared derivative contract is between the CCP and the clearing customer, and the guaranty by an FCM does not alter this analysis. This analysis is complicated since the relevant contract and agency law principles developed in a traditional bilateral setting where an agent does not provide a performance guaranty for its principal and

normally does not manage the ongoing relationship between the two parties following execution.

The BCBS (and a country's prudential regulator) could have opted to impose different requirements from those applicable to bilateral (uncleared) derivatives in designing bank capital rules. For instance, the BCBS could have chosen to forego the "master netting agreement" requirement for the netting of cleared derivatives and instead required that the national laws and the CCP rules provide for the same consequences as a master netting agreement produces upon a counterparty default (*i.e.*, immediate termination, netting and set-off) in order for a bank to take advantage of the netting benefits available for centrally cleared derivatives (and the various applications of such netting).⁸¹ This alternative approach, however, would require a comprehensive analysis of the relevant laws and regulations in each country, the CCP rules and other relevant agreements, which may prove a more difficult task than requiring that each nation's clearing framework be analyzed under existing contract and other laws which have not addressed the unique legal relationship presented by cleared derivatives. Still, we believe that the BCBS and prudential regulators should consider providing a different framework for cleared derivatives, particularly since the legal relationship in question was borne out of a

⁸¹ While the Basel III Capital Rules and other U.S. regulations generally require that cleared derivatives be subject to a QMNA in order for netting benefits to apply, the recently finalized Supplementary Leverage Ratio Rules permit a bank, in measuring its leverage ratio exposure amount, to net cash variation margin amounts for cleared derivatives if, among other conditions, the "governing rules" for such cleared derivatives (as opposed to a QMNA required for uncleared derivatives) explicitly stipulate that the parties agree to settle any payment obligations on a net basis, taking into account any variation margin received or provided under the contract if a credit event involving either counterparty occurs. While this may represent an attempt on the part of the U.S. banking agencies to permit a bank to net its cleared derivatives in reliance on the overall clearing framework, rather than a QMNA, we are not certain this properly reflects the current U.S. clearing framework for derivatives. While an in-depth discussion of the legal issues presented by the use of the phrase "governing rules" is beyond the scope of this article, we note that this phrase, although not defined or explained in the Supplementary Leverage Ratio Rules, appears inadequate, as the rights and obligations of the parties to cleared derivatives are provided not only in the CCP rules and the CFTC regulations, but also in a number of different agreements involving the CCP, the FCM and its customer. In addition, as the U.S. clearing framework does not explicitly provide for the close-out of cleared derivatives by a CCP where a credit event occurs with respect to a clearing customer (since the customer's obligations are guaranteed by its FCM), it is unclear how governing rules for cleared derivatives are expected to stipulate that payment obligations will be settled on a net basis if a credit event involving "either counterparty" occurs. (We note that the QMNA definition simply requires a bank to have the right to terminate and net its derivatives and set off its collateral upon its counterparty's default, and does not impose a corresponding requirement with respect to the bank's counterparty.)

governmental action to implement a policy choice, rather than naturally developed by market participants.