Order grants exemptive relief from Exchange Act requirements; parallel CFTC relief expected soon.

On December 14, the Securities and Exchange Commission (SEC) issued an order granting exemptive relief (Exemptive Order) from certain requirements under the Securities Exchange Act of 1934 (Exchange Act). The Exemptive Order permits (i) SEC-registered broker-dealers that also are futures commission merchants registered with the Commodity Futures Trading Commission (CFTC) (collectively, BD/FCMs) and (ii) SEC-registered clearing agencies that also are CFTC-registered derivatives clearing organizations (collectively, DCO/CAs) to commingle and portfolio margin customer positions in cleared credit default swaps (CDSs) in a segregated account established and maintained under section 4d(f) of the Commodity Exchange Act (CEA) or in a securities account under section 3E of the Exchange Act, subject to certain conditions discussed below.[1]

The exemptive relief covers CDSs that are swaps or security-based swaps and applies to BD/FCMs and DCO/CAs. The Exemptive Order became effective on December 19, 2012. The SEC is requesting public comment by February 19, 2012.

The relief in the Exemptive Order is novel because it permits portfolio margining of security-based swaps and swaps at the customer level, and permits these instruments and related margin collateral to be pooled into one account instead of two separate commodity and securities accounts as otherwise would be required. This relief is also timely given that the CFTC has recently promulgated its determination requiring that certain classes of CDSs be cleared by a CFTC-registered derivatives clearing organization.[2]

Background

Under the framework for derivatives established by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) and the way the terms "swap" and "security-based swap" are interpreted,[3] a distinction is made between Index CDSs and single-name CDSs. An Index CDS is a commodity-based swap that falls under the CFTC's jurisdiction, while a single-name CDS is a security-based swap coming under the SEC's jurisdiction. This bifurcated regulatory framework requires a customer to clear an Index CDS through a futures commission merchant on a CFTC-registered derivatives clearing organization. The customer's account at the futures commission merchant would be subject to the CFTC's customer protection rules and applicable commodity broker insolvency laws and regulations. On the other hand, a customer would have to clear a security-based swap transaction through a broker-dealer on an SEC-registered clearing agency. The customer's account at the broker-dealer would be subject to the customer protection requirements under the Exchange Act and the insolvency provisions applicable to broker-dealers (i.e., the Securities Investor Protection Act, or SIPA). While similar in many respects, there are enough differences in the SEC's and CFTC's respective customer protection and broker insolvency regimes that would make it impossible for a customer to efficiently trade and maintain a portfolio of cleared Index CDSs and single-name CDSs in the absence of portfolio margining relief.
When engaging in CDS transactions, market participants will wish to evaluate a portfolio in its entirety, including with respect to the margin and collateral requirements of the portfolio. Absent relief, a BD/FCM would have to maintain separate accounts for the collateral associated with each type of instrument in order to comply with two different sets of customer protection and insolvency requirements, and would have to collect full margin for each account without being able to take into account the risk-reducing nature of offsetting positions in a customer's portfolio of Index CDS and single-name CDS positions. Under the Dodd-Frank Act's revisions to the Exchange Act and the CEA, however, the SEC and CFTC have the ability to issue relief to alleviate the inefficiencies created by having to comply with two different sets of regulatory requirements.

Specifically, the Dodd-Frank Act added section 4d(f) to the CEA and section 3E to the Exchange Act, both of which establish a framework for segregating assets held as collateral for commodity-based swap and security-based swap transactions, respectively. These sections generally require that these assets not be commingled with a futures commission merchant's assets, in the case of a commodity-based swap transaction, or a broker-dealer's assets, in the case of a security-based swap transaction. Under section 4d(h) of the CEA and section 15(c)(3)(C) of the Exchange Act, however, the CFTC and the SEC have exemptive authority to permit a BD/FCM to portfolio margin commodity-based swaps and security-based swaps in the same account.

More specifically, under section 15(c)(3)(C) of the Exchange Act, a BD/FCM may, pursuant to a portfolio margining program approved by the CFTC, hold customer cash and securities in a portfolio margining account carried as a futures account. Similarly, under section 4d(h) of the CEA, a BD/FCM may, pursuant to a portfolio margining program approved by the SEC, hold in a portfolio margining account carried as a securities account a contract for the purchase or sale of a commodity for future delivery or an option on such a contract and assets received from a customer to margin, guarantee, or secure such contracts.

Recognizing that prior to the implementation of the Dodd-Frank Act, market participants effectively were able to commingle and margin their Index CDSs and single-name CDSs efficiently on a portfolio basis with their bilateral swap counterparty, and desiring to preserve the operational and capital efficiency of such commingled positions, as well as to facilitate the transition to central clearing and alleviate the operational and capital issues raised by the different customer protection and insolvency regimes, ICE Clear Credit and ICE Clear Europe (both registered as derivatives clearing organizations and clearing agencies) petitioned the SEC and CFTC to permit the commingling and portfolio margining of CDS assets in a CFTC-regulated account.

**SEC Exemptive Relief and Conditions**

The Exemptive Order grants the SEC portion of the relief needed by BD/FCMs by conditionally exempting DCO/CAs and BD/FCMs from certain requirements under the Exchange Act\[4\] when BD/FCMs elect to offer a program to commingle and portfolio margin customer positions in CDSs. The conditions of the Exemptive Order are outlined below. While, at the time of this writing, the CFTC has yet to issue its portion of the relief, we expect that relief to be issued relatively soon, and hopefully well in advance of the required clearing effective date for Index CDS.

**Conditions for DCO/CAs**

The exemption for DCO/CAs permits these entities to perform the functions of a clearing agency under a program to commingle and portfolio margin cleared CDSs for customer positions in accounts maintained in accordance with section 4d(f) of the CEA and the rules thereunder (i.e., a swaps account). Although the Exemptive Order lists five conditions as applicable to DCO/CAs, two of the conditions are intended to provide for portfolio margining within a securities account structure (as opposed to a swaps account structure) once the SEC adopts final rules establishing margin and segregation requirements applicable to security-based swaps consistent with section 3E of the Exchange Act\[5\].

As mentioned above, both the SEC and the CFTC need to provide relief to permit a BD/FCM to commingle and portfolio margin customer CDS positions. Accordingly, the first condition requires a DCO/CA to obtain any other relief needed to permit a BD/FCM that is a clearing member to maintain customer assets received to margin, guarantee, or secure customer positions in cleared CDSs (both commodity-based swaps and security-based swaps) in a segregated account established and maintained in accordance with section 4d(f) of the CEA and the rules thereunder. In other words, the Exemptive Order is not operationally effective until the CFTC also issues its relief.

The second condition requires a DCO/CA to have rules and operational practices in place that permit a BD/FCM to maintain customer assets in a segregated account established and maintained in accordance with section 4d(f) of the CEA and the rules thereunder.

The third condition requires that the rules of the DCO/CA require that each customer of a BD/FCM participating in a program to commingle and portfolio margin CDSs is an "eligible contract participant" as defined in section
The **fourth condition** requires the DCO/CA to have taken steps—by the later of six months after the adoption of final rules governing segregation and margin for security-based swaps or the compliance date of such rules—that are within its control to obtain relief permitting for the commingling and portfolio margining of customer assets in a section 3E account (i.e., a securities account).

Similarly, the **fifth condition** requires that a DCO/CA—by the later of six months after the adoption of final rules governing segregation and margin for security-based swaps or the compliance date of such rules—take all necessary action within its control to permit a BD/FCM to commingle and portfolio margin customer assets in a security-based swap account.

## Conditions for BD/FCMs

There are six conditions enumerated in the Exemptive Order that are applicable to BD/FCMs. Two conditions, however, will not apply in all instances: one applies when a customer is not affiliated with a BD/FCM and the other applies when a customer is affiliated with a BD/FCM. The remaining four conditions apply to all customers.

### Affiliated and NonAffiliated Customers

The **first condition**, which applies when a customer is not affiliated with a BD/FCM, requires the BD/FCM to do the following:

- Maintain customer assets received to margin, guarantee, or secure customer positions consisting of cleared CDSs in a segregated account established and maintained in accordance with section 4d(f) of the CEA and the rules thereunder.
- Enter into a nonconforming subordination agreement with each nonaffiliated customer containing (i) a specific acknowledgment by the customer that such assets will not receive customer treatment under the Exchange Act or SIPA, or be treated as customer property in a liquidation of the BD/FCM, and such assets would be subject to any applicable protections under subchapter IV of chapter 7 of title II of the Bankruptcy Code and rules and regulations thereunder; and (ii) an affirmation from the customer that all of its claims with respect to its assets against the BD/FCM will be subordinated to the claims of other securities customers and security-based swap customers not operating under a program to commingle and portfolio margin CDSs.

The requirements of the **second condition**, which applies when a customer is affiliated with a BD/FCM, are substantially similar to the requirements of the first condition, except that the BD/FCM must (i) maintain its affiliate's assets in a "Cleared Swaps Proprietary Account" as that term is defined in CFTC Rule 22.1 and (ii) obtain from the affiliate an opinion of counsel that the affiliate is legally authorized to subordinate all of its claims against the BD/FCM.

### Conditions of General Applicability

The **third condition** requires a BD/FCM to have minimum margin levels with respect to any customer transaction in an amount at least equal to the amount determined using a margin methodology established and maintained by the BD/FCM that has been approved in writing by the SEC or its staff. As explained in the Exemptive Order, the SEC intends that its staff will consult with CFTC staff and take into consideration the margin methodology established by the DCO/CA in setting customer margin levels under CFTC risk management regulations (i.e., 17 C.F.R § 39.13). The Exemptive Order further states that in reviewing margin methodologies submitted by BD/FCMs for approval—whether value-at-risk models or standardized models—the SEC or its staff will be guided by the standards outlined in Appendix E of Rule 15c3-1 of the Exchange Act.

The **fourth condition** requires that a BD/FCM be in compliance with (i) applicable laws and regulations relating to risk management, capital, and liquidity and (ii) DCO/CA rules and CFTC requirements (including segregation and related books and records provisions) for accounts established and maintained in accordance with section 4d(f) of the CEA and rules thereunder.

Under the **fifth condition**, only customers that are "eligible contract participants," as defined in section 1(a) (18) of the CEA, may participate in a program to commingle and portfolio margin CDSs.

Finally, under the **sixth condition**, before receiving any customer assets, a BD/FCM must furnish to its customer a disclosure document containing the following:

- A statement indicating that the customer's assets will be held in an account maintained in accordance with the segregation requirements of section 4d(f) of the CEA and that the customer has elected to seek
protections under subchapter IV of chapter 7 of title 11 of the Bankruptcy Code and the rules and regulations thereunder.

- A statement that the broker-dealer segregation requirements of section 15(c)(3) and section 3E of the Exchange Act and the rules thereunder, and any customer protections under SIPA and the stockbroker liquidation provisions, will not apply to such customer assets.

**Conclusion**

The Exemptive Order relief is significant because market participants who engage in CDS transactions will be able to effectively maintain the operational and capital efficiency of their current bilateral CDS positions by commingling and portfolio margining their cleared CDS positions in a single BD/FCM account. This will facilitate the transition of the CDS market to clearing, which was one of the key goals of the Dodd-Frank Act.

As noted above, the Exemptive Order is effective upon publication in the Federal Register, although a parallel order is required from the CTFC, which is expected to be issued soon. BD/FCMs should begin to review and evaluate their margin policies, procedures, account agreements, and disclosures to determine the appropriate changes that may be necessary to facilitate customer portfolio margining of CDSs.

This article was contributed to by Mark D. Fitterman and the Investment Management Practice.


[2] See Clearing Requirement Determination Under Section 2(h) of the CEA; Final Rule, 77 Fed. Reg. 74,284 (Dec. 13, 2012), available here. The final rule will be phased in over a series of dates based on the category type that a market participant comes under. For instance, Category 1 Entities, such as swap dealers, major swap participants, and active funds, must begin clearing swaps subject to the new clearing requirement on or after March 11, 2013. Category 2 Entities, such as commodity pools and private funds as defined in section 202(a) of the Investment Advisors Act of 1940 other than active funds, persons predominantly engaged in activities that are in the business of banking, or persons engaged in activities that are financial in nature according to section 4(k) of the Bank Holding Company Act, must begin clearing swaps subject to the new clearing requirement on or after June 10, 2013. Category 3 Entities, which encompass other market participants, including third-party subaccounts, must begin clearing swaps on or after September 9, 2013.


[4] In particular, the Exemptive Order provides DCO/CAs with exemptions from section 3E(b), (d), and (e) of the Exchange Act and any rules thereunder. It also provides BD/FCMs with exemptions from sections 3E(b), (d), and (e) of the Exchange Act and section 15(c)(3) of the Exchange Act and Rule 15c3-3 thereunder and from any requirement to treat an affiliate (as defined in association with the definition of “Cleared Swaps Proprietary Account” pursuant to CFTC Rule 22.1) as a customer for purposes of Rules 8c-1 and 15c2-1 under the Exchange Act.


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