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190 ACROSS THE FINISH LINE: CFTC ADOPTS NEW BANKRUPTCY RULES FOR FCMS AND DCOS

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I. INTRODUCTION

On December 8, 2020, the Commodity Futures Trading Commission ("CFTC" or "Commission") adopted comprehensive revisions to its Part 190 Rules governing a commodity broker bankruptcy ("Part 190 Amendments"), by unanimous vote of the Commissioners.[1] These significant revisions enhance customer protection, modernize the rules and bring greater clarity and transparency to the process for liquidating a futures commission merchant ("FCM") or derivatives clearing organization ("DCO") in a proceeding under subchapter IV of chapter 7 of the U.S. Bankruptcy Code, 11 U.S.C.A. §§ 101 *et seq.* (the "Code").

The rulemaking is noteworthy as well as the culmination of a multi-year collaborative effort between the Commission and private bar. In September 2017, following 2½ years of work, a subcommittee of the Business Law Section of the American Bar Association, the ABA Part 190 Subcommittee, submitted model Part 190 Rules to the CFTC for consideration.[2] The 45 plus lawyers who contributed to the effort are active in the areas of derivatives and bankruptcy law and were drawn from law firms, FCMs, DCOs, exchanges, government agencies and industry associations, along with attorneys who served as, or represented, trustees in FCM bankruptcy proceedings.[3] The group commenced its ambitious and civic-minded project to conduct a holistic review of Part 190 in early 2015 with informal support of Commission staff, certain of whom participated in several brainstorming sessions with the subcommittee.[4] The CFTC followed with its own intensive years' long effort to develop comprehensive Part 190 revisions. The Commission used the model rules as its foundation, and consulted with the ABA Part 190 Subcommittee during its deliberations. The Commission unanimously approved a proposed set of comprehensive changes to Part 190 in April 2020 for public comment,[5] and adopted comprehensive amendments on December 8, 2020. At the December meeting, Heath Tarbert, then Chair of the Commission, presented the ABA Part 190 Subcommittee with the Chairman's Award for Regulatory Excellence in recognition of its "extraordinary effort *pro bono publico* in developing a Model Part 190 that served as the foundation for the Commission's amendments to its Part 190 Bankruptcy Regulations."[6]

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The effective date for the Part 190 amendments is May 13, 2021.[7]

II. BRIEF BACKGROUND

The Code contains special provisions in subchapter IV of chapter 7 governing the trustee's liquidation of a U.S. "commodity broker," including an FCM or DCO.[8] The Code provisions are supplemented by Section 20 of the Commodity Exchange Act ("CEA"), which authorizes the CFTC to adopt rules governing the trustee's administration of a subchapter IV proceeding.[9] Section 20, in effect, tasks the Commission with providing specificity to subchapter IV's general provisions. Section 20 authorizes the Commission to determine, among other things, how the trustee should liquidate the business of the commodity broker, and the scope of what is included in or excluded from "customer property" and, for purposes of a DCO liquidation, what elements of customer property fall under the subclassification of "member property."[10]

The Securities Investor Protection Act of 1970 ("SIPA")[11] is also part of the relevant statutory framework, because many FCMs are also registered with the Securities and Exchange ("SEC") as securities broker-dealers and thus are members of the Securities Investor Protection Corporation ("SIPC"). A failing FCM that is also a broker-dealer will be subject to the filing of a protective decree by SIPC, which would commence a liquidation case under SIPA. In that scenario (as has occurred in the past), SIPC will appoint the trustee, who is responsible for liquidating both the FCM and broker-dealer business lines, subject to the Bankruptcy Court's oversight. Notably, Section 7(b) of SIPA states that when a debtor in a SIPA proceeding is also a commodity broker, the SIPC trustee has the "same duties as a trustee" under a subchapter IV proceeding, to "the extent consistent with the provisions of this chapter or as otherwise ordered by the court."[12]

Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), is also relevant to round out the statutory context. If an FCM or DCO is failing, its insolvency could potentially be handled as an orderly liquidation proceeding (*i.e.*, resolution proceeding) under Title II, as an alternative to a subchapter IV proceeding. Title II gives the Secretary of the Treasury ("Secretary" or "Treasury Secretary") the authority to appoint a receiver for a "financial company,"[13] if the Secretary first makes certain determinations.[14] If the Secretary initiates a Title II proceeding, Title II provides that the Federal Deposit Insurance Corporation ("FDIC") will become the receiver and assume control over the financial company's liquidation. The FDIC has authority to assume virtually complete control over the liquidation, subject only to limited court oversight.[15] If the financial company is a commodity broker, the FDIC is required to apply the provisions of subchapter IV of chapter 7 "in respect of the distribution to any customer of all customer property and member property," as if it were a debtor for purposes of subchapter IV.[16]

The CFTC first adopted the Part 190 Rules in 1983,[17] pursuant to its authority under Section 20 of the CEA. Although the Commission amended Part 190 over the years, it did so on an ad hoc basis, and the rules largely retained their original organization along with certain outdated provisions. Also, in its prior iterations, Part 190 applied generally to the liquidation of commodity brokers—including commodity options dealers and leverage transaction merchants as well as

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FCMs and DCOs—but the rules were largely tailored for liquidating an FCM and really only made sense when considered in that context. In particular, the rules before the recent amendments would have been challenging to apply to a DCO liquidation under subchapter IV because they contained only one rule directly relevant for a DCO liquidation, which defined the scope of member property; fortunately, we have not seen the failure of a U.S. DCO and the rules were never tested in that context. The Commission understood, however, that it was prudent to close that "hole" and propose a more robust regime of rules for a DCO liquidation.

As noted, the Commission proposed comprehensive changes to Part 190 in April 2020. The Commission received over 15 comment letters from a range of stakeholder interests, including the Futures Industry Association, International Swaps and Derivatives Association, Securities Industry and Financial Markets Association's Asset Management Group and Managed Funds Association (joint filing), Chicago Mercantile Exchange Inc., Intercontinental Exchange Inc., LCH Group, Options Clearing Corporation, Vanguard Group, National Grain and Feed Association, Commodity Markets Council, Better Markets, Inc. and the ABA Part 190 Subcommittee.[18] Commenters largely supported the proposal, while raising issues and concerns on specific features. The proposed subpart C rules governing a DCO liquidation drew the most attention. The CFTC also issued a supplemental notice of proposed rulemaking in the fall of 2020 proposing a change to the proposed subpart C rules that would have temporarily stayed termination of cleared commodity contracts in the highly unlikely event of a subchapter IV proceeding involving a systemically important DCO.[19] The stay proposal drew negative comments, and was not part of the final amendments.[20]

III. THE PART 190 AMENDMENTS

A. GENERAL

The Commission's amendments to Part 190 are comprehensive and reflect as themes enhancing the clarity and transparency of the rules, modernizing the rules and improving customer protections. The revisions build upon fundamental concepts in the prior rules, which have served the derivatives markets and market participants well in guiding the liquidation of FCMs in prior subchapter IV proceedings. Those concepts include organizing customers by public and non-public customer class;[21] organizing customer property and customers by separate account classes for futures, foreign futures, cleared swaps and delivery accounts; *pro rata* distribution of customer property by account class; and priority of public customers over non-public customers in the distribution of customer property. The first three account class distinctions generally align with the CFTC's different segregation regimes for futures, foreign futures and cleared swaps, but the fourth, the delivery account class, does not. As amended, Part 190 also retains the fundamental concept that the trustee should use "best efforts" in liquidating an FCM to transfer customer positions and account equity to another (solvent) FCM in lieu of liquidating such property.

To improve clarity and transparency, the Commission reorganized Part 190 into three subparts. Subpart A contains general provisions applicable to all proceedings under the Part 190 Rules.

Subpart B contains provisions specific to a proceeding in which the debtor is an FCM. Subpart C contains rules setting out a process for administering the liquidation of a DCO in a subchapter IV proceeding, in the highly unlikely event of a DCO failure. The subpart C rules would also serve as the counterfactual for the FDIC in the event a failed DCO is instead resolved under Title II of the Dodd-Frank Act. During the rulemaking process, the Commission assumed that the failure of a DCO would more likely (or should) result in a Title II orderly liquidation proceeding, at least in the case of a DCO that is designated as a systemically important financial market infrastructure by the Financial Stability Oversight Council under Title VIII of Dodd-Frank.

B. GENERAL PROVISIONS: SUBPART A

The amendments contain a number of general improvements to Part 190. Of particular note, the Commission added new Rule 190.00 to provide important context for understanding the other rules in Part 190. This rule explains the Commission's statutory authority to adopt the rules, the organization of Part 190, the core concepts embodied in the Part 190 Rules, the scope of the Part 190 Rules, and certain rules of construction. Among other provisions, Rule 190.00(d)(1) explicitly sets out that Part 190 is limited in scope to the commodity broker liquidation of an FCM or DCO.[22]

Rule 190.01 contains an updated and revised set of definitions for terms used in Part 190, including some new terms. Rule 190.02 sets out certain general provisions, including a new provision setting out that a receiver appointed for an FCM due to segregation or net capital violations may file a petition for bankruptcy of the FCM pursuant to Section 301 of the Code.[23]

C. FCM PROCEEDINGS: SUBPART B AND NEW PART 1 RULES

Subpart B sets out rules specific to the commodity broker liquidation of an FCM. The amended rules retain concepts in the prior rules with respect to customer class and account class distinctions, *pro rata* distribution of customer property, the priority of public customers over non-public customers, and transfer of customer positions and property, but also contain important changes to enhance customer protection. The CFTC also modified and expanded certain "business as usual" requirements imposed on FCMs under the prior rules, but moved them to new rules in Part 1 of the Commission's regulations.

Significant changes to Part 190 for an FCM liquidation include the following, among others.

- ***Customer Friendly Proof of Claim***. The Commission adopted an improved, more "customer friendly" template for the proof of claim form that the trustee may (but is not required) to use. Proof of claim forms in the past tended to be somewhat cumbersome, particularly for unrepresented parties. Rule 190.03(e) directs the trustee to request customers to provide certain prescribed information, but qualifies the obligation "to the extent reasonably practicable."
- ***Hedge Positions***. The CFTC changed the treatment of hedge accounts and positions, consistent with the overall objective that the trustee should be seeking to transfer ***all*** commodity contract positions of customers

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of the debtor FCM to one or more other (solvent) FCMs. The former rules required the trustee to treat hedge positions as a type of specifically identifiable property ("SIP"), and gave customers special rights to avoid having their hedge positions liquidated by the trustee. New Rule 190.03(c)(2) provides that the trustee only has to treat customer positions carried in a hedge account as SIP when practicable under the circumstances, following consultation with the Commission. That is more consistent with the practice in prior FCM bankruptcies, where trustees focused on porting all customer positions and individual outreach to hedgers was impractical under the circumstances.

- ***Customer Posted Letters of Credit***. The amendments clarify treatment of customer-posted letters of credit. Rule 190.04(d) provides that the trustee may require a customer that posted a letter of credit to the debtor FCM to deliver substitute customer property to the trustee, even if the letter of credit expired after the FCM entered bankruptcy. Rule 190.04(d) further provides that the trustee may draw on an unexpired letter of credit if the customer fails to post substitute customer property within a reasonable time specified by the trustee. Rule 190.04(d) also clarifies that an undrawn letter of credit (even if expired, and less the amount of any substitute customer property posted by the customer) is deemed distributed to the customer for purposes of distribution calculations, and that all proceeds of a letter of credit drawn by the trustee—as well as any substitute customer property posted by the customer—are considered customer property in the account class under which the letter of credit falls.

- ***Expanded Customer Property Definition***. The amendments expand the definition of customer property available to distribute to a debtor-FCM's customers. Under new Rule 190.09, customer property now explicitly includes (among other elements) property in the debtor FCM's estate to the extent of the FCM's obligation to maintain a targeted residual amount in segregation pursuant to CFTC Rule 1.11 or to cover debit balances or under-margined amounts in customer accounts pursuant to other CFTC rules. (This provision is not relevant for the delivery account class, with respect to which the CFTC does not impose customer funds segregation requirements, but it is relevant for the other account classes.) This provision supplements one in former Rule 190.08(a), and retained in Rule 190.09, that deems ***any*** cash, securities or other property in the FCM debtor's estate to be customer property to the extent that customer property under the other definitional elements is insufficient to satisfy in full all claims of the FCM's public customers. In 2000, the Bankruptcy Court in *In re Griffin Trading Co.*[24] ruled that the CFTC exceeded its statutory authority by adopting that provision, and that the provision was invalid. The decision was vacated on appeal, and thus should have no precedential value, but it suggests the provision may be vulnerable to legal challenge. The new provision is more robust, in that it covers property in the debtor's estate that should be covered by the definition of customer property in Bankruptcy Code Section 761(10)(A)(ix) as

"other property of the debtor that any applicable law, rule, or regulation requires to be set aside or held for the benefit of a customer."[25]

- ***FCM Residual Interest Obligations.*** New Rule 190.05(f) reinforces the expanded customer property definition. It requires the trustee to apply the residual interest provisions of CFTC Rule 1.11[26] "in a manner appropriate to the context of their responsibilities as a bankruptcy trustee pursuant subchapter IV of chapter 7 of the Bankruptcy Code and this part, and in light of the existence of a surplus or deficit in customer property available to pay customer claims."

- ***Deliveries***. The amendments provide more detail around how the trustee should handle deliveries under physical delivery commodity contracts that move into delivery position before they are liquidated. Rule 190.06(a) directs the trustee to use reasonable efforts to allow a customer to fulfill its delivery obligations directly, outside the administration of the estate, when allowed under the rules of the relevant DCO, foreign clearing organization or market. It also contains provisions for the trustee to facilitate deliveries that cannot occur outside the administration of the estate. Rule 190.06(b) contains special provisions relating to splitting the delivery account class into a cash delivery account class and physical delivery account class, which is new, and which is relevant when deliveries are effected in a delivery account.

  The amendments add related definitions to Rule 190.01 for the terms "delivery account class," "physical delivery account class," "cash delivery account class," "physical delivery property" and "cash delivery property." To be covered by the cash delivery property definition, cash or cash equivalents must be recorded on the FCM's books and records as having been received from the customer no more than seven days before the relevant first notice date (physically-settled futures) or exercise date (physically-settled options). The Commission had originally proposed a shorter 3-day time window, but extended the time as a compromise in response to comments recommending that the Commission not impose any time restriction. The Commission retained a time restriction to discourage holding of cash in an unsegregated delivery account indefinitely. The Commission wants to encourage FCMs and their customers to keep cash in segregation for as long as possible, and to transfer cash into an unsegregated delivery account only when necessary to pay for an approaching delivery obligation.

- ***Transfers***. Rule 190.07 sets out special provisions governing transfer of customer positions and accounts. The amendments made certain improvements. Rule 190.07(b)(3) allows a receiving FCM to accept transferred commodity contracts of customers prior to conducting its own customer due diligence, provided that it completes its own due diligence within six months of the transfer, unless extended by the Commission. Rule 190.07(b)(4) assigns customer agreements of the debtor FCM to the receiving FCM by operation of law. Rule 190.07(d)(4) requires the trustee to

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use reasonable efforts to prevent physical delivery property from being separated from transferred commodity contract positions under which the property is deliverable. This change addresses a problem that occurred in the *MF Global* bankruptcy in which certain physical delivery property held for the purpose of making delivery under commodity contracts was not ported, while the commodity contracts were swiftly ported. This created a significant issue for customers in the early stages of that case. The addition of Rule 190.07(d)(4) serves as a partial fix of that issue.

Prior to the amendments, Part 190 contained certain provisions that applied to FCMs during business as usual.[27] The revisions proposed in April 2020 contained modified business as usual terms, set out in proposed Rule 190.10, which addressed current books and records, designation of hedge accounts, delivery accounts and standards for letters of credit that an FCM may accept. In response to comments, the Commission adopted those requirements in substance, but moved the provisions to new rules in Part 1 of the Commission's regulations. The new Part 1 rules include the following:

- ***Rule 1.41 Designation of hedge accounts***. As before, an FCM must provide a customer the opportunity to designate an account as a "hedge account" at the time of account opening. However, in place of using the hedge instruction form, the FCM may rely upon the customer's representation that the account carries positions that constitute hedging "as such term may be defined under any relevant Commission regulation or rule of any clearing organization, designated contract market, swap execution facility or foreign board of trade." The FCM "must indicate prominently in the accounting records in which it maintains open trade balances whether, for each customer account, the account is designated as a hedging account." The new requirements do not apply to accounts opened prior to the May 13, 2021 effective date of the new Part 190 Rules; for such accounts, an FCM may continue to rely upon hedge instructions it received from a customer in accordance with former Rule 190.06(d).

- ***Rule 1.42 Delivery accounts***. The rule is relevant for an FCM when it facilitates or effects the transfer of physical delivery property and related payment on behalf of a customer in connection with making or taking delivery under a physical delivery commodity contract. It provides that if the transfer occurs outside a futures account, foreign futures account or cleared swaps account, the FCM must effect the transfer in a delivery account or, in the case of a security, in a securities account. Previously, Part 190 indirectly imposed on FCMs the obligation to use a delivery account.

- ***Rule 1.43 Letters of credit as collateral***. The rule imposes requirements on FCMs with respect to accepting letters of credit from customers as collateral. It provides that an FCM "shall not accept a letter of credit as collateral unless such letter of credit may be exercised through its date of expiry" under two conditions, "regardless of whether the customer posting that letter of credit is in default in any obligation."

First, the letter of credit must provide that a trustee in an FCM bankruptcy or SIPA proceeding, or a receiver under Title II of the Dodd-Frank Act, must be able to draw on the letter of credit in accordance with Rule 190.04(d)(3). Second, if the FCM passes a letter of credit through to a DCO, the pass-through letter of credit must provide that a trustee in a DCO bankruptcy, or a receiver under Title II of Dodd-Frank, must also be able to draw on the letter of credit in accordance with Rule 190.04(d)(3). An FCM has until April 13, 2022 to comply with Rule 1.43 with respect to letters of credit that the FCM has accepted before the May 13, 2021 effective date of the new rules. This delayed compliance also applies with respect to customer agreements that an FCM enters into prior to May 13, 2021, which would seem to cover letters of credit an FCM accepts after May 13 from any customers that are parties to those agreements.

- ***Rule 1.55(p) Disclosure statement for non-cash margin.*** The Commission retained an FCM's obligation under former Rule 190.10(c) to provide customers with a prescribed disclosure statement for non-cash margin, but now sets that out in Rule 1.55, which prescribes other public disclosures that an FCM must provide to its customers.

D. DCOs: SUBPART C

The subpart C rules are specific to a subchapter IV proceeding in which the debtor is a DCO. They fill a void in the former rules, and provide much needed clarity on what to expect if a DCO becomes the subject of a formal liquidation proceeding, whether under subchapter IV or an orderly liquidation proceeding under Title II of the Dodd-Frank Act administered by the FDIC. In the latter case, it is important to have clear rules that provide guidance to the FDIC on how to distribute "member property" and customer property other than member property, if called upon to administer the liquidation of a DCO in a Title II proceeding.

The subpart C rules drew the most comment during the rulemaking process. Certain commenters objected to giving deference to the DCO's default rules and wind-down and recovery plans and raised issues regarding DCO governance and decision-making, which the Commission declined to address in the final amendments as out of scope.

Commenters also objected to the Commission's original proposal to include a provision in Rule 190.14(b) that would allow the trustee to continue to make variation settlement and initial margin calls for up to six days, under certain conditions and with the Commission's permission. They expressed concern that the provision could be contrary to DCO closeout netting rules and undermine DCO netting opinions. In response, the Commission issued a supplemental notice of proposed rulemaking in which it proposed to replace that feature with a provision that would stay temporarily, subsequent to the order for relief, the exercise of rights under the DCO's rules to terminate cleared contracts upon the event of the DCO's bankruptcy.[28] The Commission noted its intention that both proposals would facilitate transfer of a DCO bankruptcy case to a Title II proceeding under the Dodd-Frank Act. In the supplemental proposal, the Commission expressed its view that the Treasury Secretary

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and relevant banking agencies may need time to complete the process to initiate a Title II proceeding, and highlighted that termination rights may be at odds with the prospect that the FDIC could transfer the DCO's clearing operations to another entity in a Title II proceeding. The temporary stay provision also drew criticism, including that the stay was unnecessary and that the Commission lacked authority[29] to adopt a rule that would negate statutory protections of clearing members' closeout netting rights under Section 362 and various ''safe harbor'' provisions of the Code[30] and Section 4404 of the Federal Deposit Insurance Act ("FDIA").[31] The Commission did not include either proposal in the final Part 190 Rules.

The Commission had also initially proposed including in Rule 190.18 a provision that would allocate guaranty fund deposits, assessments or similar payments to customer property other than member property in any account class if there were a shortfall in the funded balance to satisfy the claims of clearing members' public customers in any account class. Some commenters objected that the proposal could conflict with DCO rules that limit application of a clearing member's guaranty fund deposits to losses in the relevant clearing service covered by the guaranty fund (*i.e.*, to the same account class).[32] The CFTC also removed that feature from the final subpart C rules.

The following discussion describes the main features of the subpart C rules.

- ***Rule 190.11 Scope and purpose of subpart C***. Rule 190.11(a) sets out that subpart C applies to a subchapter IV proceeding in which the debtor is a "clearing organization," *i.e.*, a registered DCO. In response to comments, the Commission added paragraph (b), which identifies the limited provisions of Part 190 that would apply if the debtor DCO is organized outside the U.S. and subject to a "foreign proceeding" as defined in Section 101(23) of the Code.[33]

- ***Rule 190.12 Required reports and records.*** Rule 190.12 addresses the means for providing notices to the Commission and clearing members, and requires a debtor DCO to provide notice to the Commission if it files a petition in bankruptcy or has a petition filed against it. The rule also requires the DCO to provide the trustee with certain reports and records required under specified Commission rules, such as current versions of its default management plan, rules and procedures, and of any recovery and wind-down plans.

- ***Rule 190.13 Prohibition on avoidance of transfers***. Rule 190.13 protects certain pre- and post-relief transfers to another DCO from avoidance by the trustee under Code Sections 544, 546, 547, 548, 549, or 724(a) (*i.e.*, including preference and fraudulent transfer actions under the Code). The Commission must approve post-relief transfers, which it may do either before or after the transfer.

- ***Rule 190.14 Operation of the estate of the debtor subsequent to the filing date.*** Rule 190.14(a) allows the trustee, in its discretion, to instruct customers (which would be the clearing members) to file proofs of claim containing such information as the trustee deems appropriate, and to seek a

court order to establish a bar date for filing the proofs of claim.

Rule 190.14(b) requires the DCO to cease making calls for variation settlement or initial margin subsequent to the order for relief. As noted, the Commission had initially proposed that the trustee could continue to make variation settlement and initial margin calls for up to six days with the Commission's permission under certain conditions and then later proposed replacing that provision with one that would stay temporarily the exercise of clearing members' termination rights.

Rule 190.14(c) requires the trustee to liquidate open commodity contracts within seven calendar days after entry of the order for relief that have not yet been terminated, liquidated or transferred. The liquidation must be in accordance with the debtor DCO's rules and procedures, to the extent applicable and practicable.

Rule 190.14(d) provides that the trustee must use reasonable efforts to compute a funded balance for each customer account immediately prior to distributing property within the account.

- ***Rule 190.15 Recovery and wind-down plans; default rules and procedures***. Rule 190.15(a) prohibits the trustee from seeking to avoid or prohibit any action taken by the debtor DCO that was reasonably within the scope of and provided for in any recovery and wind-down plans of the DCO that were filed with the Commission pursuant to CFTC Rule 39.39.[34] Rule 190.15(b) requires the trustee to implement, in consultation with the Commission, the DCO's default rules and procedures maintained under CFTC Rule 39.16 and, as applicable, CFTC Rule 39.35,[35] and any termination, closeout and liquidation provisions included in the debtor DCO's rules. The trustee's obligation is subject to its reasonable discretion and is limited to implementing the default rules and procedures to the extent practicable. Rule 190.15(c) requires the trustee, in consultation with the Commission, to take actions in accordance with any recovery and wind-down plans maintained by the debtor DCO that were filed with the Commission pursuant to CFTC Rule 39.39, to the extent reasonable and practicable, and (in an addition to the proposed rule) consistent with the protection of customers.

- ***Rule 190.16 Delivery.*** Rule 190.16 requires the trustee to use reasonable efforts to facilitate deliveries on behalf of a clearing member or its customer in a manner consistent with subpart B's Rule 190.06(a) and the *pro rata* distribution concepts set out in subpart A's Rule 190.00(c)(5). As proposed, this obligation was limited to commodity contracts that have moved into delivery position prior to the date and time of the bankrupt DCO's order for relief, but in response to comments, the Commission revised the final rule so that it also applies to commodity contracts that move into delivery position after the date of the order for relief. The rule also contains special provisions relating to the division of the delivery account class into separate physical delivery and cash delivery account classes.

- ***Rule 190.17 Calculation of net equity.***

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Rule 190.17 addresses how to calculate each clearing member's net equity claims. Rule 190.17(a) provides that if a clearing member clears trades through a customer account and separately through a house account, the clearing member is treated as having customer claims against the debtor DCO in those separate capacities, and also separately by account class. The rule further states that the clearing member is treated as part of the public customer class with respect to claims based on its customer account(s) at the DCO and as part of the non-public customer class with respect to claims based on its house account(s) at the DCO. Net equity is calculated separately for the clearing member's customer and house accounts and by account class.

Rule 190.17(b)(1) requires "full application" of the DCO's loss allocation rules and procedures, including default rules and procedures, to the calculation of a clearing member's net equity claim. It further states that this calculation includes, "with respect to the clearing member's house account, any assessments or similar loss allocation arrangements provided for under those rules and procedures that were not called for before the filing date, or, if called for, have not been paid" and (added in response to comments) that "[s]uch loss allocation arrangements shall be applied to the extent necessary to address losses arising from default by clearing members."

Conversely, Rule 190.17(b)(2) allows for adjustment of clearing members' net equity claims to reflect their entitlement to return of guaranty fund deposits or other mutualized default resources that are not used, or to payments out of amounts that the DCO recovers on claims against a defaulting clearing member.

Rule 190.17(c) provides that net equity is "calculated in the manner provided in § 190.08, to the extent applicable." Rule 190.08 is the subpart B counterpart for calculating net equity for the accounts of customers of a debtor FCM.

Rule 190.17(d) provides that a clearing member's *pro rata* share of customer property other than member property (for its customer accounts at the DCO) and of member property (for its house accounts) with respect to each account class is calculated as provided in Rule 190.08(c) (*i.e.*, the same manner as with respect to customers of an FCM).

- ***Rule 190.18 Treatment of property***. Rule 190.18(a) sets out the general principle that property of the debtor's estate "must be allocated between member property and customer property other than member property." Rule 190.18(b) defines the scope of customer property by account class, and lists the various items within the scope of customer property. They include, among others, (i) open commodity contracts and margin deposits received and held by the DCO, (iii) any "guaranty fund deposit, assessment, or similar payment or deposit made by a clearing member, or recovered by the trustee, to the extent any remains following administration of the debtor's default rules and procedures, and any other property of a member available under the debtor's rules and procedures to satisfy claims made by or on behalf of public customers of a member;" and (iii) "[a]mounts

of its own funds that the debtor had committed as part of its loss allocation rules, to the extent that such amounts have not already been applied under such rules." The latter was not part of the proposed rules, but the Commission added it at the recommendation of a DCO commenter.

Rule 190.18(c) sets out standards for allocating excess funds available to satisfy claims in respect of clearing members' house accounts or customer accounts within an account class. As a general matter, excess will be applied first to satisfy the shortfall in the funded balance to satisfy claims of public customers in any account class, before excess is applied to satisfy a shortfall in the funded balance to satisfy claims of non-public customers in any account class, in each case potentially jumping across account classes. As noted, the Commission did not adopt its initial proposal to jump across account classes to allocate guaranty fund deposits, assessments or similar payments to satisfy claims in respect of clearing members' customer accounts.

- ***Rule 190.19 Support of daily settlement***. Rule 190.19 supports the daily settlement process, by addressing treatment of variation settlement payments that the DCO received but had not disbursed to clearing members entitled to variation gain payments. Rule 190.19(a) provides that variation settlement funds must be included in customer property and will be distributed to clearing member accounts. Rule 190.19(b) addresses the situation when there is a shortfall in the funds that the DCO receives pursuant to paragraph (a), for example, due to a clearing member default. As noted, Rule 190.14(b) does not allow (as originally proposed) the trustee to make calls subsequent to the order for relief for variation payments (or initial margin) under any circumstances. Thus, it appears that Rule 190.19 would only be relevant in circumstances when a settlement cycle was underway at the debtor DCO but not completed at the time of the order for relief.

IV. *GRIFFIN TRADING* ISSUES: STILL THE NEED FOR A LEGISLATIVE FIX?

As noted above, the Part 190 Rules (both as amended and before) provide that if "customer property" is insufficient to satisfy public customer claims in full, all other cash, securities or other property of the FCM's estate would be classified as customer property to the extent of such shortfall.[36] If enforced, this provision essentially provides a super-priority to public customers over all assets of the bankrupt FCM ahead of the debtor's non-customer, unsecured creditors. In other words, unsecured creditors would never recover anything in an FCM bankruptcy unless the FCM's public customers were paid in full.

In light of the decision in *Griffin Trading* (discussed above), it is an open question whether this rule is enforceable.[37] The amendments largely close this loop by adding a more targeted provision to the customer property definition that classifies assets of a debtor FCM as "customer property" if there is a shortfall available to distribute to public customers, which is linked to an FCM's obligations under other CFTC rules to deposit its own funds into the relevant segregated funds pool to cover a segregation shortfall or undermargined amounts as well as to provide for a

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cushion of "excess" segregated funds. Specifically, Rule 190.09(a)(1)(ii)(G) states that customer property includes "current assets of the debtor (as of the date of the order for relief) within the meaning of § 1.17(c)(2) of this chapter, including the debtor's trading or operating accounts and commodities of the debtor held in inventory, in the greater of (i) the amount that the debtor is obligated to set aside as its targeted residual interest amount pursuant to § 1.11 of this chapter and the debtor's residual interest policies adopted thereunder, with respect to each of the futures account class, the foreign futures account class, and the cleared swaps account class, or (ii) the debtor's obligations to cover debit balances or under-margined amounts as provided in §§ 1.20, 1.22, 22.2 and 30.7 of this chapter." This provision (along with Rule 190.09(a)(1)(ii)(H)[38]) should not have the same vulnerability to legal challenge because it aligns with an element of the Code definition of customer property that covers "other property of the debtor that any applicable law, rule, or regulation requires to be set aside or held for the benefit of a customer."[39]

Notably, however, this "fix" with respect to *Griffin* does not cover delivery property, which FCMs are not required under current CFTC rules to segregate or "set aside" for the benefit of their customers with delivery accounts.[40] Accordingly, absent legislative action such as proposed in the CFTC Reauthorization Act of 2019,[41] or the Commission's adoption of custody requirements for delivery accounts (discussed below), customers of a bankrupt FCM could be subject to a fight over the "*Griffin* issue" with respect to whether they have priority over general unsecured creditors with respect to all assets of the FCM.

V. POTENTIAL AREAS FOR FOLLOW-UP ACTION BY THE COMMISSION

There are certain potential areas that may result in follow-up action by the Commission, which arose during the Part 190 amendments rulemaking process but are outside the four-squares of Part 190.

One area involves property held in delivery accounts, which as discussed above, is not subject to customer funds segregation requirements under current CFTC rules. As the trustee and other parties learned in the *MF Global* bankruptcy, it can be more difficult to identify customer property for the delivery account class, in particular for tracing cash. Indeed, that is the main reason for dividing the delivery account class into separate account classes for cash delivery property and physical delivery property for purposes of pro rata distributions to public customers on their net equity claims in the delivery account class. Commenters generally supported that change, but the Commission was also encouraged to consider adopting custody requirements for delivery accounts. We concur that this recommendation merits consideration. Such a requirement would enhance protections for customers in the delivery account class, and eliminate the need to limit when cash may be posted to a delivery account to qualify as cash delivery property (discussed above). It could also avoid the "*Griffin* issue" for delivery property as noted above.

The Commission has general rulemaking authority under CEA Section 8a(5) to promulgate rules that are, in its judgement, "reasonably necessary to effectuate any of the provisions or to accomplish any of the purposes" of the CEA.[42]

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We believe a custody rule for delivery account property could be justified as appropriate to accomplish the purposes reflected in the segregation requirements set out in CEA Section 4d,[43] but to the extent those provisions may not cleanly fit, the Commission could also (or instead) perhaps rely upon the general anti-fraud provisions in CEA Sections 4b or 6(c).[44] In that regard, we note that the SEC promulgated its rule requiring registered investment advisers to hold property in custody for their customers relying on its anti-fraud authority under the Investment Advisers Act of 1940.[45]

DCO risk governance is another area of potential CFTC rulemaking. A number of commenters objected to applying a DCO's recovery and wind-down plans and default rules in a DCO proceeding, lobbying for changes to the CFTC's Part 39 and 40 Rules with respect to how DCOs adopt such plans and rules. The Commission determined that those issues should not delay the Part 190 rulemaking, but noted that it "continues actively to review these issues, in particular with respect to governance, as they relate to parts 39 and 40."[46]

The Commission may also consider amending the DCO notice provisions in Part 39. As noted, commenters objected to the Commission's proposal to add a temporary stay provision to Rule 190.14(b). Commenters stated that it was unnecessary to impose a stay as a means to provide the Treasury Secretary and other relevant agencies the time to complete the steps to trigger an orderly liquidation proceeding of the DCO under Title II of the Dodd-Frank Act. The CFTC agreed with commenters that the CFTC (and by extension the other agencies) should be well aware of an impending DCO bankruptcy under the DCO oversight framework, including the DCO's existing notice obligations under Part 39. Nonetheless, the Commission indicated that it may be appropriate to consider amending the notice requirements in Part 39 to require a DCO to provide advance notice before it files for bankruptcy.[47]

Finally, when the ABA Part 190 Subcommittee submitted the model rules to the Commission, it proposed certain changes to other Commission rules. Among others, the subcommittee recommended that the Commission consider revising the definition of "proprietary account" in CFTC Rule 1.3 to narrow the scope of persons (including affiliates) that are denied the protections afforded to public customers of an FCM, and proposed revisions to the definitions of "foreign option" in CFTC Rule 30.1(d) and "variation margin" in Rule 1.3. When the Commission first proposed the Part 190 amendments, it noted that "these proposals merit due consideration" but "in light of practical limits to staff time and resources," it stated that it would separately address them later.[48]

VI. CONCLUSION

The Commission's updated Part 190 Rules are the culmination of a multi-year project to build upon and improve the foundations underlying FCM and (potential) DCO bankruptcy cases. The result is a robust regime that comprehensively modernizes the Part 190 Rules and improves customer protections and transparency. Indeed, the process of amending the Part 190 Rules involved a commendable public-private partnership to work together and "get it right" for the benefit of participants in cleared derivatives markets subject to the CEA regime.

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ENDNOTES:

[1]*Part 190 Bankruptcy Regulations,* 86 FR 19324 (Ap. 13, 2021) ("Final Part 190 Amendments"). A link to the voting draft ("Part 190 Voting Draft") is available at https://www.cftc.gov/PressRoom/PressReleases/8331-20. For a detailed discussion of the proposed amendments, relevant statutory provisions and pre-amended Part 190 Rules, *see* K. Trkla and G. Goodman, *Finally 190! Years in the Making: CFTC Proposes New Bankruptcy Rules for FCMs and DCOs,* FDLR (May 2020).

[2]The subcommittee electronically submitted the transmittal letter and draft model Part 190 Rules in two filings. The transmittal letter also provides background on the ABA Part 190 Subcommittee and the model Part 190 Rules. The filings are available at https://comments.cftc.gov/PublicComments/CommentList.aspx?id=1807.

[3]The ABA Derivatives and Futures Law and Business Bankruptcy Committees jointly formed the Part 190 Subcommittee in February 2015. The Part 190 Subcommittee is co-chaired by Vince Lazar on behalf of the Business Bankruptcy Committee and Kathryn Trkla on behalf of the Derivatives & Futures Law Committee.

[4]Commission staff took great care not to influence or direct the ABA Part 190 Subcommittee's deliberations.

[5]*Bankruptcy Regulations*, 85 FR 36000 (June 12, 2020) (notice of proposed rulemaking) ("Part 190 Amendments NPR"). The CFTC also issued a supplemental notice of proposed rulemaking in September 2020. *Bankruptcy Regulations*, 85 FR 60110 (Sept. 24, 2020) (supplemental notice of proposed rulemaking).

[6]An image of the award is available on the ABA Derivatives and Futures Law Committee's Subcommittee page at https://www.americanbar.org/groups/business_law/committees/derivatives/subcommittees/ under the description for the Part 190 Subcommittee.

[7]The effective date is set based on publication of the adopting release in the Federal Register. In recent years, there has been significant delay between when the Commission approves a notice of proposed rulemaking or adoption of final rules and when the Federal Register publishes that action. The voting draft was nearly 500 pages in length, which likely contributed to the over 4 month delay between the Commission's approval of the Part 190 amendments on December 8, 2020 and publication of the adopting release in the Federal Register on April 13, 2021.

[8]11 U.S.C.A. §§ 761-767. A commodity broker is not eligible to file bankruptcy under chapter 11, which is the Code's reorganization chapter. Almost all FCMs are organized and located in the U.S., as are most DCOs, but a few are non-U.S. The bankruptcy of a non-U.S. FCM would likely be administered under a main proceeding in the FCM's home jurisdiction, not under a subchapter IV proceeding and the Part 190 Rules.

[9]7 U.S.C.A. § 24.

[10]Section 20(a) states:

> Notwithstanding title 11 of the United States Code, the Commission may provide, with respect to a commodity broker that is a debtor under chapter 7 of title 11 of the United States Code, by rule or regulation—
>
> (1) that certain cash, securities, other property, or commodity contracts are to be included in or excluded from customer property or member property;
>
> (2) that certain cash, securities, other property, or commodity contracts are to be specifically identifiable to a particular customer in a specific capacity;
>
> (3) the method by which the business of such commodity broker is to be conducted or liquidated after the date of the filing of the petition under such chapter, including the payment and allocation of margin with respect to commodity contracts not specifically identifiable to a particular customer pending their orderly liquidation;
>
> (4) any persons to which customer property and commodity contracts may be transferred under section 766 of title 11; and
>
> (5) how the net equity of a customer is to be determined.

Subchapter IV of chapter 7 also recognizes the

CFTC's authority in key areas. For example, Section 766(d) [11 U.S.C.A. 766(d)(2)] gives the CFTC authority to protect against the trustee avoiding transfers of commodity contracts and associated cash or other property that occur before the seventh day after the order for relief. As another example, Section 766(h) [11 U.S.C.A. § 766(h)] recognizes the CFTC's authority to adopt rules defining customers whose accounts are classified as "proprietary accounts" of the commodity broker, whose claims in an FCM commodity broker liquidation are subordinated to those of public customers.

[11]15 U.S.C.A. §§ 78aaa *et seq*.

[12]15 U.S.C.A. § 78fff-1(b).

[13]A financial company is a company that (i) is incorporated or organized under U.S. federal or state law; (ii) is (A) a bank holding company, (B) a nonbank financial company supervised by the Board of Governors, (C) a company "predominantly engaged in activities that the Board of Governors has determined are financial in nature or incidental thereto for purposes of section 1843(k) of this title," or (D) a subsidiary of a company described in any of the foregoing that is "predominantly engaged in activities that the Board of Governors has determined are financial in nature or incidental thereto for purposes of section 1843(k) of this title (other than a subsidiary that is an insured depository institution or an insurance company);" and (iii) is not chartered under and subject to the Farm Credit Act of 1971, or a governmental or regulated entity, as defined in section 4502 of this title. 12 U.S.C.A. § 5381(a)(11).

[14]12 U.S.C.A. § 5383(b). As an initial step, the Secretary would receive recommendations from the FDIC and the Board of Governors of the Federal Reserve. To initiate a Title II proceeding, the Secretary, must determine, among other things, that (i) the financial company is in default or in danger of default; (ii) its failure and resolution under other applicable law would "have serious adverse effects on financial stability" in the U.S.; (iii) a viable private sector alternative for preventing the default is not available; (iv) any effect on the claims or interests of creditors or certain other interested parties resulting from actions taken under Title II are appropriate given the impact that such actions would have on U.S. financial stability; and (v) any action taken would avoid or mitigate the adverse effects, taking into consideration the action's effectiveness in "mitigating potential adverse effects on the financial system, the cost to the general fund of the Treasury, and the potential to increase excessive risk taking on the part of creditors" and certain other interested parties.

[15]12 U.S.C.A. §§ 5390(a) and 5390(e). The FDIC may create a "bridge financial company" to receive the transfer of selected assets and liabilities of the covered financial company, and may sell the company's assets to one or more transferees without court approval or advance notice to creditors or shareholders. 12 U.S.C.A. §§ 5390(h) and 5390(a)(1)(G).

[16]12 U.S.C.A. § 5390(m)(1)(B).

[17]*Bankruptcy,* 48 FR 8716 (March 1, 1983).

[18]The comment letters are available at https://comments.cftc.gov/PublicComments/CommentList.aspx?id=3097.

[19]*Bankruptcy Regulations*, 85 FR 60110 (Sept. 24, 2020) (supplemental notice of proposed rulemaking).

[20]The CFTC received comment letters on the supplement from CME, ICE, SIFMA AMG and MFA (joint filing), and FIA, each generally opposing the temporary stay. The comment letters are available at https://comments.cftc.gov/PublicComments/CommentList.aspx?id=4160.

[21]A "non-public customer" is generally a customer holding a "proprietary account" at an FCM such as an affiliate or controlling person of the debtor and certain other insiders; all other customers are "public customers."

[22]This is set out in new Rule 190.00(c)(1). *See also* new Rule 190.00(d)(1), which confirms that Part 190 applies to an FCM that is classified as a "foreign futures commission merchant" under the definitions in section 761 of the Code, by virtue of clearing transactions in futures or options on futures listed on a foreign board of trade. New Rule 190.00(d)(1)(i)(B) notes that

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there are no commodity options dealers or leverage transaction merchants, which are separate commodity broker categories under the Code, and sets out the Commission's intention to adopt rules for the liquidation of a commodity options dealer or leverage transaction merchant at such time as an entity registers in that capacity. The new rules will be codified at 17 C.F.R. §§ 190.00(c)(1), 190.00(d)(1)(i)(A) and 190.00(d)(1)(i)(B).

[23]11 U.S.C.A. § 301. Section 301 sets out that a debtor may commence a voluntary case under a chapter of title 11 by filing a petition with the bankruptcy court under such chapter. It further provides that commencement of a voluntary case under a chapter of title 11 constitutes an order for relief under that chapter.

[24]*In re Griffin Trading Co.*, 245 B.R. 291, Comm. Fut. L. Rep. (CCH) P 28040 (Bankr. N.D. Ill. 2000), *judgment vacated*, 270 B.R. 882 (N.D. Ill. 2001).

[25]11 U.S.C.A. § 761(10)(A)(ix).

[26]17 C.F.R. § 1.11.

[27]Such provisions were principally set out in former Rules 190.06(d) and 190.10.

[28]*Bankruptcy Regulations*, 85 FR 60110 (Sept. 24, 2020) (supplemental notice of proposed rulemaking).

[29]CME also challenged the CFTC's action as exceeding its authority under CEA Section 20 of the CEA and as contrary to the CEA rulemaking framework. CEA Section 5b(c)(2) grants a DCO "reasonable discretion in establishing the manner by which a derivatives clearing organization complies with each core principle described in" Section 5b(c), subject to requirements the Commission may impose pursuant to its separate authority under CEA Section 8a(5) prescribing how a DCO would comply with the core principles. 7 U.S.C.A. § 7a-1(c)(2).

[30]11 U.S.C.A. § 362(o). Section 362(o) of the Code states that a person's exercise of rights under certain other Code provisions "shall not be stayed by order of a court or administrative agency in any proceeding under this title." The rights protected include contractual rights of a master netting agreement participant under a master netting agreement, which notably includes rights under a DCO's rules. *See* 11 U.S.C.A. §§ 362(b)(27), 362(o), 555, 556, 559 and 560.

[31]11 U.S.C.A. § 4404(h). This provision protects the netting rights that clearing members that are financial institutions have under a DCO's rules notwithstanding "any State or Federal law" other than certain enumerated statutes. It states:

> The provisions of any security agreement or arrangement or other credit enhancement related to one or more netting contracts between any 2 members of a clearing organization shall be enforceable in accordance with their terms (except as provided in section 561(b)(2) of title 11), and shall not be stayed, avoided, or otherwise limited by any State or Federal law (other than section 1821(e) of this title, section 1787(c) of this title, and section 78eee(b)(2) of title 15.

[32]CME challenged the proposed rule as outside the Commission's authority under Section 20 of the CEA, on the basis that it was inconsistent with the Code's definition of "member property" in Section 761(16). CME also noted that the proposal was contrary to the CEA rulemaking framework and CFTC Rule 39.35(a), which provides that a systemically important DCO must adopt rules and procedures for allocating losses.

[33]11 U.S.C.A. § 101(23). This provisions states:

> The term "foreign proceeding" means a collective judicial or administrative proceeding in a foreign country, including an interim proceeding, under a law relating to insolvency or adjustment of debt in which proceeding the assets and affairs of the debtor are subject to control or supervision by a foreign court, for the purpose of reorganization or liquidation.

[34]17 C.F.R. § 39.39. This rule applies to a systemically important DCO or to a DCO that elects to comply with the special requirements for systemically important DCOs set out in subpart C of Part 39.

[35]17 C.F.R. §§ 39.16 and 39.35. Rule 39.16 applies generally to DCOs. Rule 39.35 applies only to a systemically important DCO or to a DCO that elects to comply with the special re-

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quirements for systemically important DCOs set out in subpart C of Part 39.

[36]*See* Rule 190.09(a)(1)(ii)(L) (former Rule 190.08(a)(1)(ii)(J)).

[37]*In re Griffin Trading Co.*, 245 B.R. 291, (Bankr. N.D. Ill. 2000), *judgment vacated*, 270 B.R. 882 (N.D. Ill. 2001).

[38]In addition, Rule 190.09(a)(1)(ii)(H) provides that customer property includes "other property of the debtor that any applicable law, rule, regulation, or order requires to be set aside for the benefit of customers," which corresponds to a provision in the pre-amended Part 190 Rules.

[39]11 U.S.C.A. § 761(10)(A)(ix).

[40]We also note that is unclear whether an intangible asset of a bankrupt FCM as of the order for relief, such as a litigation claim against a third party unrelated to customer property or a future tax refund, would fall within the *Griffin* "fix" in the amendments. Futures, foreign futures and cleared swaps customers therefore may still be fighting the "*Griffin* issue" with respect to these types of intangible assets in the event of a shortfall in customer property in a future FCM bankruptcy.

[41]CFTC Reauthorization Act of 2019, H.R. 4895, 116th Cong. (2019). Congress has yet to act on this bill.

[42]7 U.S.C.A. § 12a(5).

[43]7 U.S.C.A. § 6d.

[44]7 U.S.C.A. §§ 6b and 9(c), respectively.

[45]The Investment Advisers Act of 1940 is codified at 15 U.S.C.A. § 80b-1 *et seq.* The SEC's custody rule for investment advisers is set forth at 17 C.F.R. § 275.206(4)-2.

[46]Final Part 190 Amendments, *supra* note 1, 86 FR at 19373.

[47]*Id*. 86 FR 19387. The Commission states that "it should engage in further analysis and development before proposing this, or any other, alternative approach" and "will, at present, keep this issue under advisement." *Id*.

[48]Part 190 Amendments NPR, *supra* note 5, 85 FR at 36042.

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