An LSOC Tutorial: A New Customer Protection Model for Cleared Swaps Begins

By Joanne Morrison

In November U.S. futures commission merchants and swaps clearinghouses will begin offering a new customer protection regime that differs from the traditional futures segregation model. This new customer protection model, called Legally Segregated Operationally Commingled, or LSOC, is a requirement established by Commodity Futures Trading Commission rules under the Dodd-Frank reforms. LSOC applies only to customer positions in cleared products that are in the U.S. swaps regulatory class, such as interest-rate swaps, credit-default swaps, and FX and commodity swaps and forwards. LSOC does not apply to futures.

The primary goal of LSOC is to protect cleared swaps customers from "fellow customer risk"—the risk that customers of an FCM could sustain losses if other customers of that same firm fail to satisfy payment obligations to the firm. LSOC is different from the traditional customer segregation model for futures accounts in many ways.

The LSOC rules were approved by the CFTC in January, and compliance was mandated by Nov. 8. However, it has taken months of discussions among market participants, including central counterparties (CCPs), sell-side firms, and buy-side firms, to determine how to implement LSOC requirements. Because of the tight deadline, the major swaps clearinghouses have each adopted a phased approach to implementing LSOC. The first phase is set for a Nov. 5 launch in a manner that minimizes the operational and systems work. The second phase will then start in 2013.

At an FIA workshop held in New York in September, representatives from CCPs and FCMs spent an afternoon discussing how the new LSOC rules will be implemented initially. CME, ICE and LCH.Clearnet representatives explained their plans for implementing the new protections.

"This is a work in progress," said Arthur Magnus, managing director, and global head of futures and options and OTC clearing core operations at J.P. Morgan, who moderated the September workshop.

What is LSOC?

LSOC is designed to be an extension of the customer segregation model for U.S. futures. In the U.S. futures model, an FCM must hold customer funds physically separate from its "house" funds. This separate pool of assets is called the "segregated funds pool." At all times the firm must ensure that it maintains at least as much value in the segregated funds pool as is required to cover its liabilities to customers. Because the firm must often meet obligations of its customers to clearinghouses before it can collect from those customers, it must add a significant cushion of its own assets into the segregated funds pool.

The bank accounts or custody accounts that hold client assets, whether at the FCM or at a clearinghouse, are often referred to as "client omnibus accounts," because they hold assets of many individual customers pooled together.

Each day the FCM must perform a "segregation calculation" in which it verifies that it is in compliance with the segregation requirements. The FCM must file a daily electronic report showing its segregation calculation with its designated self-regulatory organization, and under newly-adopted DSRO regulations, the DSRO must be provided with electronic access to the firm's bank accounts to be able to verify that the funds are there.

Under LSOC, as applied to customer positions in cleared swaps, the firm must perform a daily segregation calculation in exactly the same way as it does for futures. And client assets are still pooled together, exactly as with futures. However, the FCM must assure the clearinghouse that when it meets a margin call to a clearinghouse for customer positions, it never uses value provided by one customer to meet an obligation of another customer. This requires FCMs to perform a more precise calculation of each customer's obligations to the clearinghouse.

If one or more customers were to default to the FCM, and the FCM, in turn, defaulted to a clearinghouse in the customer origin, the clearinghouse can use value attributable to a particular customer only to cure losses of that customer—and not for any other customer.

To achieve these results, there are three key operational implications: 1) Clients must be identified to each clearinghouse at which they hold positions, 2) The clearinghouse must know the specific positions of each client, and 3) The collateral value for each client on deposit with the clearinghouse must be reported by the FCM to that clearinghouse at least daily.

Because it is critical for the clearinghouse to know the collateral value of each client, the CFTC's LSOC regulations focus extensively on the question of "excess" collateral—i.e., collateral value provided by the client in excess of the minimum initial margin requirement for that client. The regulations provide each clearinghouse with a choice.

In the first alternative, the CCP may allow FCMs to pass a client's collateral value to the CCP in excess of the client's minimum margin requirement. If so, however, the CCP must provide the FCM with a means to provide a daily report of that value. This is called "client-specific collateral value reporting."

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> **ED GOGOL,** *CME Group*

Alternatively, the CCP could elect not to support client-specific collateral value reporting. This latter choice is referred to as the "no excess" model or the "unallocated excess" model. In this model, the protected value for each customer is defined as the client's initial margin requirement, and the CCP does not know the customer-specific attribution of any excess collateral value that the FCM provides to the CCP. If the FCM were to default to the CCP in the customer origin, the CCP could not use that unallocated excess value to cure losses of any customers, and would have to return it to a bankruptcy trustee when directed to for the benefit of the clients.

Because of the tight deadlines, all three major swaps CCPs have elected to implement LSOC first in the "no excess" or "unallocated excess" model but will make the "client-specific excess" model available to FCMs and customers in 2013.

Client Identification, Onboarding and Position Reporting

All three CCPs indicated that they do not expect the processes for client identification, onboarding or position reporting to change significantly, and that they are already in compliance with these aspects of the LSOC rules.

The LSOC regime requires FCMs to identify each customer to the clearinghouse the first time that the FCM clears a swap for that customer and then to provide information to the clearinghouse to identify the customer's positions at least once each business day.

Helen Fermor, credit business manager at ICE Clear Credit, explained that from an ICE perspective, when an FCM onboards new clients, it is required to identify the client legal entity. "We call it a desk ID and we assign that to the client legal entity," she said. "So there should be no change to the client onboarding process."

The CFTC's LSOC rule requires the positions of each client to be disclosed to the clearinghouse at least once per day. This rule is embodied in the regulatory language that refers to the client's "portfolio of rights and obligations." For swaps products at all three CCPs, the end client is identified at the time the trade is submitted for clearing, and hence there is real-time reporting of the portfolio of rights and obligations for each customer. The FCM's obligation under this rule is to reconcile its books and records at least once per day with the data files provided by the CCPs, which clearing firms already do.

The Initial Implementation Phase of LSOC

LSOC will be implemented in a two-phase approach.

Initially, FCMs will be required to operate in the so-called "no excess" or "unallocated excess" mode, which is designed to have minimal operational impact on FCMs beyond the daily LSOC compliance calculations. In this initial mode, there is no requirement for daily client-specific collateral value reporting from the FCM to the CCP. And if a clearinghouse is holding client excess collateral, the CCP cannot use it for any purpose. In the event of a default, this excess collateral would be returned to the bankruptcy trustee.

"In this first phase, any amount of collateral that the FCM gives to CME in excess of the minimum margin requirement is deemed unallocated client excess. And in a default, the clearinghouse can't use any of that excess to cover any client's losses," said Ed Gogol, managing director, clearing architecture at CME Group.

Fermor explained that in the first phase, ICE will not use excess funds on deposits to cover an initial margin requirement. ICE will identify customer accounts with initial margin increases compared to the prior end-of-day settlement cycle and then issue a margin call to cover the sum of those customer initial margin increases. This will be called the LSOC top-up requirement. "For LSOC compliance, we will be required to issue a margin call for the sum of client deficits," Fermor said. Even if a customer within the FCM omnibus account has a decrease in its initial margin requirement and another customer has an increase, ICE can no longer offset them. "This is to ensure that one customer's excess can't be used to meet another customer's requirement," Fermor said. Once an initial margin call has been met, an FCM has the option to request a withdrawal of any excess.

FCMs will face more of an operational impact under LCH.Clearnet SwapClear's first phase of LSOC implementation. This initial phase is similar to ICE and CME's plan, but there will be more frequent margin calculations because LCH.Clearnet issues intraday margin calls. "Every time we accept a trade, we recalculate the required margin," said Nathan Ondyak, senior vice president and product manager at LCH.Clearnet's SwapClear.

LSOC Phase 2 – Full Client-Specific Value Reporting

In 2013 clearinghouses will amend their rules to permit customers to hold excess collateral at the clearinghouse. This means that the FCMs will be required to provide a collateral value report to each CCP at least once per day.

This report breaks down the ownership interest in the collateral assets provided by the FCM to the CCP. This includes an amount for each customer and an amount provided by the FCM itself or the "firm-contributed assets." The amount attributable to each customer is then considered as the "legally segregated value" for that customer. In the event of a default, the CCP may use that value only to cover the losses of that customer and for no other purpose.

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LCH.Clearnet's Ondyak indicated that in February, SwapClear will move forward with its client-specific LSOC excess model, but on an optional basis. "We will likely have a cut-off date where all members need to be on the 'with excess model' but we have not put a timeframe one that yet," said Ondyak. He also explained that once firms make this transition, it applies to all customer accounts. In other words, an FCM cannot be in a "no excess mode" for certain clients and in excess mode for others.

ICE's Fermor also pointed to a February timeframe for beginning to support full client-specific excess. "We haven't made any decisions about when we will require all FCMs to adopt that mode and provide that reporting," said Fermor.

CME will begin allowing FCMs to operate in the client-specific excess mode as early as Feb. 4. CME's Gogol emphasized that it is very much in the FCMs' interest to get to this second phase as soon as possible, as it will reduce the financing impact of LSOC. CME's deadline for firms to convert to the client-specific mode is May 27.

Challenges Remain

Diana Shapiro, North America head of OTC clearing product development at Citigroup Global Markets, explained that there still remain open issues on, among other things, how variation margin factors into the LSOC calculation and the treatment of foreign collateral. She cautioned that LSOC could present FCMs with liquidity issues. Also, Shapiro explained that once firms begin moving to the second phase of LSOC, which accommodates excess funds, they may need to perform their LSOC calculations multiple times a day. This is because under LSOC, firms cannot withdraw any excess collateral value of clients until the specific clients whose excess is being withdrawn have been identified.

"You can't just call us up and say I want to take out excess. We have to know who it's for," agreed LCH.Clearnet's Ondyak.

Shapiro also highlighted the operational and compliance costs. "There is an IT build associated with this, and resource and personnel requirements," Shapiro said.

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"The CFTC has been very, very clear. They are not moving this deadline. We need to comply," Shapiro said.

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