THE FOUNDATION FOR SECURE MARKETS

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July 13, 2020

VIA CFTC PORTAL

Christopher Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Re: RIN 3038-AE67: Bankruptcy Regulations

Dear Mr. Kirkpatrick,

The Options Clearing Corporation ("OCC") appreciates the opportunity to provide the Commodity Futures Trading Commission ("CFTC" or "Commission") with its comments on the Commission's proposed regulations amending requirements governing insolvency proceedings of commodity brokers, including registered futures commission merchants ("FCMs"), and adopting requirements governing insolvency proceedings of registered derivatives clearing organizations ("DCOs") (collectively, "Proposed Rules").[1]

About OCC

OCC, founded in 1973, is the world's largest clearing organization for equity derivatives and the sole clearing agency for all U.S. options exchanges. OCC operates under the jurisdiction of both the CFTC (as a DCO for certain commodity futures and options on commodity futures) and the Securities and Exchange Commission ("SEC"). In July 2012, the Financial Stability Oversight Council designated OCC as a systemically important financial market utility ("SIFMU") under Title VIII of the Dodd-Frank Act. As a SIFMU, OCC is also subject to oversight by the Board of Governors of the Federal Reserve System.

Summary

We support the Commission's proposal to update its regulations governing the bankruptcy proceedings of commodity brokers and adopt regulations governing the bankruptcy proceedings of DCOs. Particularly, we support that in drafting the Proposed Rules the Commission considered current market practices, lessons learned from previous bankruptcies, and recommendations submitted by the Part 190 Subcommittee of the Business Law Section of the American Bar Association, a cross-representational committee of market participants.[2] We further support the Commission's stated policy objectives, including the preference for public customers over non-public customers in a bankruptcy,[3] granting a trustee discretion to determine an appropriate approach that prioritizes cost effectiveness and promptness in the context of a particular

[1] Bankruptcy Regulations, 85 Fed. Reg. 36000 (June 12, 2020).

[2] *See generally*, *Id.* at 36001-02.

[3] *See, e.g.*, *Id.* at 36002.

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bankruptcy,[4] and general reliance by a trustee on a DCO's pre-existing default management arrangements and recovery and wind-down plan.[5] However, we offer comments on certain amendments that may have unintended consequences, which interfere with the Commission's policy objectives, and request clarification on how these general policy objectives would apply in specific contexts. Our specific comments on the Proposed Rules are discussed in more detail below.

I. A trustee should decide whether to port or liquidate considering the particular facts and circumstances of an FCM bankruptcy proceeding

The Commission has proposed new § 190.00(c)(4), which would establish a policy preference for transferring or porting, as opposed to liquidating, the open commodity contract positions of a bankrupt FCM's public customers.[6] The Commission asserts "[p]orting mitigates risks to both the customers of the debtor FCM and to the markets"[7] and "porting [rather than liquidating] of customer positions protects customers' hedges from changes in value between the time they are liquidated and the time, if any, that the customer may be able to re-establish them."[8] The Commission also asserts that the liquidation of an FCM's book of positions can increase volatility, which may make it more expensive for customers to re-establish a liquidated position.[9]

We support the Commission's objectives to mitigate risk to an FCM's customers and limit market volatility. Porting positions and associated collateral in an FCM bankruptcy proceeding can be an effective way to achieve these objectives in some instances; however, we believe the trustee should retain broad discretion to decide whether porting or liquidating positions will achieve the best result for the customers involved in a particular FCM bankruptcy. This case-by-case approach would allow the trustee to consider the defaulting FCM's total book of positions, market conditions and other factors that may contribute to liquidation achieving the best result for all or a subset of customers. While liquidating a position may introduce market risk to certain customers, porting positions also has several negative externalities. When porting a position: (i) a trustee (or DCO) must first identify a transferee to accept the open position and collateral, which depending on market conditions could be a difficult and time consuming process; (ii) until the transfer is complete, the customer may face uncertainty as to how its position and associated collateral will be resolved and may not be able exit the position in a timely and efficient manner; and (iii) a customer may be required to post additional collateral at a new FCM prior to or immediately after a transfer. Each of these potential drawbacks should be weighed against the market risk associated with closing out and reopening a position, particularly if an FCM to accept the transfer is not immediately identified.

II. We request clarification on the scope of "public customer" in a DCO bankruptcy proceeding

The Commission has proposed new § 190.00(c)(3)(i), which would establish a policy

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[4] *See, e.g.*, *Id.*

[5] *See, e.g.*, *Id.*

[6] *See, e.g.*, *Id.* at 36004.

[7] *Id.*

[8] *Id.*

[9] *Id.*

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preference for the claims of public customers over non-public customers,[10] and new § 190.00(c)(3)(ii), which would establish, in the context of a DCO bankruptcy:

> *[t]he classification of customers as non-public customers in contrast to public customers also would be relevant, in that each member of the [DCO] would have separate claims against the [DCO] with respect to (A) transactions cleared for its own account or for any of its non-public customers and (B) transactions cleared on behalf of the public customers of the member. In such a proceeding, customer property would consist of member property, which could be distributed to pay member claims based on members' house accounts, and customer property other than member property, which would be reserved for payment of claims for the benefit of members' public customers.*[11]

Proposed § 190.01 would create mutually exclusive definitions of "public customer" and "non-public customer,"[12] which would have different practical applications in the context of an FCM bankruptcy and a DCO bankruptcy.[13] In a DCO bankruptcy, "customers of clearing members (whether such clearing members are FCMs or foreign brokers) acting on behalf of their proprietary (*i.e.*, house) accounts, would be non-public customers, while all other customers of clearing members would be public customers."[14] Therefore, in determining whether a futures account held by an FCM at a DCO is a non-public customer account, a non-public customer account would be generally synonymous with a "proprietary account" as defined in 17 C.F.R. § 1.3.[15]

We support the Commission's policy objective to prefer claims of public customers over non-public customers in an FCM or DCO bankruptcy proceeding. We also agree that, in the context of a DCO bankruptcy, claims against a DCO's estate could be generally separated into claims of a DCO's public and non-public customers. In determining whether a claim against a DCO's estate is on behalf of an FCM's public customers or house/non-public customers, we request clarification on how a trustee would classify such claims. Specifically, we understand an FCM's non-public customer claims, as linked to the definition of "proprietary account" under § 1.3, would include an FCM's house positions and entities that are affiliates of, and/or under common control with, the FCM, and that all other claims would be classified as public customer claims. The Commission should also clarify whether customers of a foreign broker that access a DCO through an FCM clearing member affiliated with the foreign broker will be treated as public customers for purposes of the Proposed Rules.

III. A trustee's discretion to issue a margin call could be challenged by a customer

The Commission has proposed amended § 190.01 and new § 190.04(b) that would, in part, provide a trustee discretion to call for and collect additional margin from a bankrupt FCM's customers, to facilitate a transfer of a customer's open commodity contract rather than liquidation, and require a trustee to liquidate an open customer contract under certain

[10] *See Id.* at 36002-04 and 36075-76.

[11] *Id.* at 36004. *See also Id.* at 36076.

[12] *Id*. at 36009-10 and 36080-81.

[13] *See, e.g.*, *Id*. at 36009-10 and 36075-76.

[14] *Id.* at 36010.

[15] *Id.* at 36080.

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circumstances. Specifically:

- Proposed § 190.01 would define an account as "under-margined" "if the funded balance for such account is below the minimum amount that the debtor is required to collect and maintain for the open commodity contracts in such account under the rules of the relevant clearing organization, foreign clearing organization, [Derivatives Contract Market], Swap Execution Facility, or [Foreign Board of Trade]."[16]

- Proposed § 190.04(b)(2) would establish that a "trustee (or, prior to appointment of the trustee, the debtor against which an involuntary petition was filed) *may* issue a margin call to any public customer whose commodity contract account contains open commodity contracts if such account is under-margined"[17] (emphasis added), and thereby "remove the current requirement that the trustee issue such margin calls, by replacing the term "must issue margin calls" with "may issue a margin call," in light of the possibility that the trustee will determine it impracticable or inefficient to do so."[18]

- Proposed § 190.04(b)(4) would establish a "trustee's obligation to liquidate certain open commodity contracts, in particular, those in deficit and those where the customer has failed promptly to meet a margin call,"[19] and that a "trustee *shall*, as soon as practicable, liquidate all open commodity contract accounts in any commodity contract account (i) that is in deficit; (ii) for which any mark-to-market calculation would result in a deficit; or (iii) for which the customer fails to meet a margin call made by the trustee within a reasonable time."[20] (emphasis added)

The proposed amendments appear to provide a trustee discretion to determine not to issue a margin call to a public customer, even if the public customer's account is under-margined, if a trustee believes it would be impractical or inefficient to do so. Conversely, a trustee would be required to liquidate all open contracts in a customer's account that is in deficit (or would be in deficit after applying mark-to-market calculations). We note that this proposed discretion not to issue a margin call to an under-margined customer, combined with an obligation to liquidate a customer account that is in deficit or on the threshold thereof, could result in claims of inequitable treatment by an FCM's public customers. Specifically, this could create a situation in which a trustee offers one public customer an opportunity to deposit additional margin that ultimately prevents an account deficit and resulting liquidation of the public customer's account, but exercises discretion not to offer another public customer the same opportunity to deposit margin and subsequently must liquidate the account because it is in deficit, notwithstanding the customer's willingness to post additional margin to keep its positions open. The use of such discretion exposes a trustee to challenge by a public customer that asserts, though it was similarly situated to a public customer that was given this opportunity, it was not given this opportunity and received inequitable treatment.

[16] *Id.* at 36011 and 36081.

[17] *Id.* at 36011.

[18] *Id.* at 36017.

[19] *Id.*

[20] *Id.* at 36018.

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IV. The Commission should adopt rules permitting DCOs to delay due diligence on members that accept open positions in a bankruptcy

The Commission has proposed new § 190.07(b)(3), which would permit an FCM accepting transferred positions from a bankrupt FCM to:

> *accept open commodity contracts and property, and open accounts on its records, for customers whose commodity contracts and property are transferred pursuant to this part prior to completing customer diligence, provided that account opening diligence as required by law is performed, and records and information required by law are obtained, as soon as practicable, but in any event within six months of the transfer, unless this time is extended for a particular account, transferee, or debtor by the Commission.*[21]

We note that DCOs also have rules and governance arrangements by which they review requests from their members to clear additional product types through the DCO. DCOs have established such programs, in part, to comply with the Commission's regulations in 17 C.F.R. § 39.12 requiring a DCO to have "continuing participation requirements for clearing members of the [DCO] that are objective, publicly disclosed, and risk based."[22] Since the Commission acknowledges that such due diligence performed in the ordinary course may need to be delayed in a bankruptcy to facilitate an expedient transfer of customer positions, we recommend the Commission adopt a parallel regulation permitting a DCO to postpone any due diligence the DCO would typically have to perform on an FCM member accepting transferred positions from a bankrupt FCM.

V. We agree that customers posting letters of credit as margin should not be treated differently than other customers

The Commission has proposed new § 190.04(d)(3) to codify its existing policy that "customers who post letters of credit as margin would be treated no differently than other customers and thus would suffer the same pro rata loss"[23] by permitting a trustee to require a customer that has posted a letter of credit as collateral to provide substitute collateral, or else requiring the trustee to draw on the letter of credit and subtract any undrawn amount from the customer's pro rata share of the proceeds in the estate.[24]

We support proposed § 190.04(d)(3) and the policy objective it is intended to promote. We also note that OCC expects it would generally, to the extent permitted by OCC's rules and default

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[21] *Id.* at 36088.

[22] 17 CFR § 39.12(a). *See also* 17 C.F.R. § 240.Ad-22(e)(18), an analogous rule under the Securities Exchange Act of 1934 requiring a designated covered clearing agency to:

> *establish, implement, maintain and enforce written policies and procedures reasonably designed to, as applicable. . . [e]stablish objective, risk-based, and publicly disclosed criteria for participation, which permit fair and open access by direct and, where relevant, indirect participants and other financial market utilities, require participants to have sufficient financial resources and robust operational capacity to meet obligations arising from participation in the clearing agency, and monitor compliance with such participation requirements on an ongoing basis.*

[23] 85 Fed. Reg. at 36019.

[24] *Id.* at 36019-20.

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management arrangements, draw on a defaulted member's letter of credit collateral as soon as practicable after a declaration of default. OCC would attempt to do so, whether or not it has immediately identified a need to draw on a letter of credit to meet the defaulted member's settlement obligations, as a protective action in anticipation of any potential increase in the credit risk associated with the letter of credit. In such cases, a trustee would obtain any remaining proceeds from the drawn-down letter of credit to distribute pro rata among the FCM's customers as appropriate.

The Commission has also proposed new § 190.07(d)(3), which would establish "that a letter of credit associated with a commodity contract may be transferred with an eligible commodity contract account if it is held by a DCO on a pass-through basis or if it is transferable by its terms," subject to a customer's entitlement to pro rata proceeds elsewhere in the Proposed Rules.[25] We support the objective of proposed § 190.07(d)(3) but note that, in practice, letters of credit are often issued to the benefit of a specific FCM and by their terms are not transferrable with customer positions. In such cases, a customer may need to provide substitute collateral.

VI. A DCO should be required to provide the Commission and trustee with certain information as soon as practicable, but within three hours is overly prescriptive

The Commission has proposed new § 190.12(b), which would require a DCO to provide a trustee and the Commission within three hours after an insolvency proceeding has commenced and the trustee is appointed, as applicable, with (i) copies of various reports filed with the Commission; (ii) the DCO's default management plan, rules, and procedures; and (iii) the DCO's recovery and wind-down plan.[26] We generally support a requirement for a DCO to provide a trustee and the Commission with information they need for efficient resolution of the DCO, and recognize that because time would be of the essence in such a proceeding this information must be made available quickly. We also note that since this information is periodically reported to, or filed with, the Commission pursuant to Parts 39 and 40 of the Commission's regulations,[27] respectively, OCC maintains this information in a readily accessible place and does not foresee any challenge in identifying and providing this information without delay.

However, we believe that a specific deadline of three hours is overly prescriptive, and a DCO may need additional time to provide this information due to unforeseen delays that could occur on the day in which the DCO enters bankruptcy. Therefore, we suggest that § 190.12(b) require a DCO to provide this information as soon as practicable.

VII. The Commission should further consider whether continued operation of a DCO by a trustee would be practical

The Commission has proposed new § 190.14(b)(2), which would permit a trustee to, upon request and approval by the Commission, continue to operate a DCO in bankruptcy for up to six calendar days.[28] In determining whether such an arrangement would be feasible, a trustee must believe such arrangement would be "useful" and "practical," as described in

[25] *Id.* at 36025.

[26] *Id.* at 36094.

[27] 17 C.F.R. §§ 39.1 *et seq.* and 40.1 *et seq.*

[28] 85 Fed. Reg. at 36095.

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proposed § 190.14(b)(2)(i)-(ii).[29]

We note additional considerations in determining whether continued operation of a DCO in bankruptcy would be practical and understand that many market participants are concerned about the implications of proposed § 190.14(b)(2) on closeout netting opinions. Specifically, the Commission has determined that for continued operation to be practical, (i) all (or substantially all) the DCO's non-bankrupt members must cooperate and (ii) the DCO's rules cannot compel termination of all (or substantially all) open contracts upon the DCO entering bankruptcy.[30] However, a DCO may also maintain contractual arrangements with various counterparties, including Designated Contract Markets, other trade sources, other DCOs, banking and liquidity providers, and information technology vendors, that are necessary for the DCO's continued operation but that the applicable counterparty could terminate upon the DCO's entry into bankruptcy. Therefore, a trustee would need to review the DCO's recovery and wind-down plan and/or consult with a DCO to determine whether such arrangements necessary for the DCO's continued operation would – or could – be terminated upon the DCO's entry into bankruptcy and, if so, determine whether the counterparties to such agreements would continue to provide those necessary services for a period of time. Furthermore, the Commission should continue to consult with DCOs and market participants who rely on closeout netting opinions to ensure that the Proposed Rules do not raise uncertainty related to the enforceability of DCOs' closeout rules or have other unintended consequences.

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We thank the Commission for the opportunity to provide comment on the Proposed Rules. If you have any questions, please do not hesitate to contact me at 312.322.7570, or JKamnik@theocc.com. We would be pleased to provide the Commission with any additional information or analyses that might be useful in determining the content of the final regulations.

Sincerely,

Joseph P. Kamnik

[29] *Id.*

[30] *Id.*