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Are Customer Segregated/Secured Amount Funds Properly Protected After *Lehman*?

BY: RONALD H. FILLER

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The short answer is “yes” for the most part with respect to customer assets held in a customer segregated account in the United States but major changes to the procedures and policies now in place are needed to provide greater customer protection safeguards, especially in connection with assets held outside the United States in CFTC Regulation 30.7¹ secured amount accounts, regarding trading on non-U.S. futures exchanges.

Most mystery authors normally wait until the last few pages of the last chapter to provide the final clues and solve the mystery. This is, however, a different mystery story even if it's filled with suspense, exciting themes and horror. And for those who do not believe that the role that segregated and secured amount funds play in today's global futures markets is not mysterious and challenging, then they must have slept through the period of the last two weeks in September and most of October. What we all believed were the rules to be applied in the event of an FCM's bankruptcy were all interpreted differently by the various global exchanges and clearing houses. Some clearing houses,

like EUREX Clearing AG, LCH Clearnet SA, the CME Clearing House, ICE Clear US and The Clearing Corporation, acted admirably and professionally while others acted in a manner that was not necessarily in the best interests of futures customers.² This article will explain what many of us in the futures industry understand to be the role of customer segregated and secured amount accounts, then explain what occurred after Lehman Brothers Holdings Inc., the parent company of Lehman Brothers Inc. (“LBI”), filed for Chapter 11 protection and then provide several recommendations of best practices that this global industry should now consider. Since the brokerage firms today are truly global in their customer and product base, any future solution must be a global approach.

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Introduction

With the demise of Bear Stearns Securities (“Bear”) in March 2008 and now the bankruptcy of LBI, many futures customers have raised serious questions and concerns regarding how and whether their funds held by a futures commission merchant (“FCM”) are protected under such circumstances.³ Similarly, given the recent credit crisis, the government loans provided to American International Group (“AIG”), the acquisition of Merrill Lynch by Bank of America, the \$700 billion bailout approved by Congress and numerous other financial-related matters, customers of broker-dealers (“BD”), insurance companies and banks have raised similar concerns. Not to underestimate the importance of insolvencies involving these other financial institutions, this article will only address the laws, regulations and policies that impact futures customers globally under such circumstances.⁴

Rules Governing Futures Accounts at an FCM

Substantial financial safeguards and customer protections exist within the futures industry that are designed to protect customer funds in the event of an FCM bankruptcy. Assets held in a futures account at an FCM are protected and governed specifically by applicable laws and CFTC regulations that require the segregation of cash and collateral deposited by customers in conjunction with their futures trading. Pursuant to the Commodity Exchange Act (“CEA”)⁵ and applicable CFTC regulations⁶, an FCM, must maintain its futures customer assets in at least two different types of customer fund accounts (e.g., segregated and secured amount accounts) and may use a third type (e.g., a non-regulated account), each of which have different priority rights in the event of the FCM’s insolvency.

The three types of customer fund accounts used by an FCM are:

1. **SEGREGATED FUNDS:** The first such account, established pursuant to Section 4d(a) (2) of the CEA⁷ and CFTC Rule 1.20, is referred to as the “customer segregated funds

account”. It holds the assets of *all customers* (U.S. and non-U.S.) deposited in conjunction with transactions on all *U.S. futures markets*. All customer assets are required to be held only in accounts maintained at custodial banks and other permitted financial institutions, including other FCMs and clearing houses that are registered with the CFTC as “derivatives clearing organizations” (DCOs). All customer segregated accounts are required to be clearly identified as segregated pursuant to CFTC Rule 1.20. These segregated funds are not permitted to be commingled with the FCM’s proprietary funds or used to finance its futures or broker-dealer businesses. The amounts held in the segregated funds accounts are calculated daily as required by CFTC Rule 1.32, and the FCM must take immediate action in the unlikely event that there is ever a shortfall in its segregated funds accounts. This daily calculation must be completed by each FCM by not later than noon on the next business day. However, the customer segregated required amount needs to be in a good control location⁸ the night before. Otherwise, the FCM is deemed to be “under segregated”, and, if the FCM is “under-segregated”, this must be reported promptly to the CFTC and its respective DSRO.⁹ Given this same-day deposit requirement, most large FCMs will deposit a large amount of their own capital in the customer segregated account to ensure that such accounts are never “under-segregated”. This capital infusion can amount to several hundred million dollars, depending on the total amount held in the segregation pool.

2. **SECURED AMOUNT FUNDS:** The second type of account, governed by CFTC Rule 30.7, is known as the “customer secured amount account” and holds the assets of *U.S. residents* deposited in conjunction with their transactions on *non-U.S. futures markets*. These funds are also required to be held in accounts at banks and other permitted financial institutions, including non-U.S. clearing houses and members of non-U.S. exchanges,

provided such non-U.S. clearing houses and non-U.S. member firms are deemed to be a “good secured” location. Like segregated funds, secured amount funds are not permitted to be commingled with the FCM’s proprietary assets and are calculated daily and represent 100% of that day’s customer requirements.¹⁰ FCMs are permitted to secure more than the minimum requirement stated above and can elect to deposit all funds used to trade on non-U.S. markets by all of its clients, including foreign domiciled clients. Like segregated funds as noted above, the calculation for the secured amount requirements must be completed by the following morning but the secured amount requirement must be deposited in a good secured location the night before or the FCM will be deemed to be in default.¹¹ As noted above with customer segregated accounts, most large FCMs will also deposit their own capital in a secured amount account to prevent any under-funding from occurring

3. **NON-REGULATED FUNDS:** The third type of account, called the “Non-Regulated Customer Credit” calculation, contains the assets (cash and open trade equity) of *non-U.S. customers* deposited in conjunction with transactions on *non-U.S. futures markets* if such amounts are not included in the secured amount account as noted above.¹² An FCM, also registered as a broker-dealer, may use this third account type, which is governed by Securities and Exchange Commission (“SEC”) Rule 15c3-3. The amounts held in this account reflect the total of the credit balances calculated for each individual account owed by the FCM to its non-U.S. customers for transactions on *non-U.S. futures markets* less any deposits of cash or securities held with a clearing organization or correspondent clearing broker.¹³ Any amounts held in a non-regulated account are not covered by the provisions of the Securities Investor Protection Act (“SIPA”).

Each “bucket”, noted above, contains funds used by customers to margin the relevant futures

products, with the difference being whether the futures products are traded on U.S. or non-U.S. futures markets and, for non-US markets only, whether the customer is a U.S. or a non-U.S. entity.

In addition to the segregation and secured amount requirements, CFTC regulations restrict where client funds may be placed. CFTC Rule 1.20 requires the FCM to maintain customer segregated funds, whether in the form of cash or collateral, either with a clearinghouse of a U.S. futures exchange registered with the CFTC as a DCO, in a customer segregated account with a bank or with another FCM. In connection with its custodial arrangement, the FCM must obtain what is known as a “segregation acknowledgment letter”, commonly known as a “seg. waiver letter”, in which the respective custodial bank or FCM acknowledges and agrees that all assets deposited in this segregated account are for the sole benefit of the FCM’s futures customers and are not subject to the claims of any of the FCM’s creditors, including that bank or FCM, respectively. Similar letters must also be obtained for the Rule 30.7 secured amount account and the Rule 15c3-3 non-regulated account at the respective custodial bank. All customer assets are therefore held at all times in these accounts at the respective custodial bank or FCM, in accounts at the various clearing houses or with other clearing brokers that act as clearing brokers on the various exchanges around the globe on behalf of the FCM.

RECOMMENDATION #1: While the CFTC does not specifically require the use of non-regulated accounts, as this is primarily an SEC requirement for broker-dealers, the CFTC should now prohibit the use of non-regulated accounts by an FCM, that is also registered as a broker-dealer, and require that all funds held by an FCM to margin non-U.S. futures, whether they be for the benefit of a U.S. customer or a non-U.S. customer, be held in a 30.7 Customer Secured Amount Account. This prohibition will prevent any misappropriation of futures customer funds held in a 15c3-3 account as such accounts could arguably be deemed to fall outside the protections afforded by CFTC regulations 1.20 and 30.7.

An FCM is also required by CFTC regulations to properly account for and calculate on a daily basis both the amount that it is required to hold in segregation and the amount that actually is in its customer segregated accounts.¹⁴ Any deficiencies in the amounts required must be remedied and reported immediately to the appropriate regulators. Most large FCMs deposit a substantial amount of their own capital in the customer segregated account to provide excess funds in the event a futures customer does not timely meet its margin requirements. This capital infusion may also be used to satisfy customer claims in the event of the FCM's insolvency. Similarly, to provide additional protections to its customers, the FCM must report, in accordance with applicable CFTC regulations, to the appropriate regulators within 24 hours if its net capital falls below the "early warning" level and must promptly add additional capital to bring its net capital above this level.¹⁵

In the event of the FCM's bankruptcy,¹⁶ futures customer assets are normally protected except as described below. First, assuming no material futures customer-related default exists or was the cause of the FCM's bankruptcy (e.g., the insolvency was the direct result of a non-futures customer or transaction), a bankruptcy filing should have no material impact on customers' assets held in the three aforementioned accounts. Under such circumstances, each account should contain 100% of the required amounts and should be transferred back to customers in an orderly fashion. An FCM bankruptcy would be administered under Chapter 7 of the U.S. Bankruptcy Code, which contains specific provisions for the protection of customers in the event of an FCM's insolvency. Under Part 190 of the CFTC's rules, the bankruptcy trustee would have the responsibility of returning the custodied assets back to each futures customer. Creditors of the FCM's bankrupt estate would have no claim to any of the assets held in these three accounts. The assets would be held solely for the benefit of the FCM's futures customers.

If, on the other hand, the FCM's bankruptcy resulted from a futures customer's failure to deliver the required margin for its futures trading positions, and the default was greater than all of

the shareholder equity of the FCM, then each of the three accounts held at the custodian bank (or an FCM) would be treated independently of each other. Customers' assets held in one of these three accounts may not be used to satisfy any shortfalls in another account (e.g., the amounts held in the segregated account at the respective custodial bank or at a DCO may not be used to cover a shortfall held in the non-regulated account). However, as noted in greater detail below, a clearing house, including a DCO, may apply a clearing member firm's customer assets that are on deposit with that respective clearing house to satisfy margin amounts owed to the clearing house by that clearing member firm (and that clearing member firm only) for its customer accounts. In other words, customer assets held by a clearing house may not be used to cover a shortfall in the FCM's "house" account nor may assets held at one clearing house be applied to cover a shortfall at another clearing house unless a cross-margining arrangement exists with respect to the two clearing houses.

The assets of an FCM's futures customers, which trade on the U.S. futures markets, are normally wired directly by those customers into the customer segregated account at the respective custodial bank. The custodian bank would typically maintain different segregated accounts to hold cash and any non-cash collateral, such as U.S. Treasury bills, respectively. This firewall between the bank and the FCM provides important protections to the FCM's futures customers. As noted above, the assets held in these accounts at the bank do not fall within the bankrupt estate and are reserved for payment to customers if the FCM files for bankruptcy. If the bank mishandles futures customers' assets held with the FCM, its full shareholder capital should stand behind the accounts.

If the FCM is required by an exchange to send cash or collateral to a DCO to meet its customers' initial or variation margin requirements, the required amounts are typically sent via wire transfer from the customer segregated account at the respective custodial bank or FCM to another customer segregated account held in the name of the DCO for the benefit of the FCM's futures customers. Therefore, at all times, assets of the FCM's fu-

tures customers, who trade on U.S. futures markets, are held in a customer segregated account at the FCM's or the DCO's custodial bank. Similarly, assets that need to be transferred to clearing brokers or clearing houses outside the U.S. are also sent directly from the 30.7 Secured Amount Account at the bank to the required good secured location.

Investments of Futures Customer Assets

There are also customer protections relating to the types of permissible investments that an FCM may make with customer assets held by the FCM. Pursuant to CFTC Rule 1.25, the FCM is permitted to invest its futures customers' assets in a limited number of permissible investments.¹⁷ In today's marketplace, the most commonly used investment product are money market mutual funds that meet the requirements of CFTC Rule 1.25 and SEC Rule 2a-7 under the Investment Company Act of 1940 (the "1940 Act"). However, any investment loss that may be incurred as a result of such investment must be borne solely by the FCM; its futures customers assume no such investment risk.¹⁸ This concern has been heightened recently by The Reserve Fund which lost a substantial amount of its investment assets through its purchase of commercial paper held in the name of Lehman Brothers and AIG, causing the fund to "break the buck".¹⁹ Also, the FCM must receive an acknowledgement from each money market fund that the amounts invested by the FCM on behalf of its customers with the respective money market fund may not be applied to any creditor of the FCM. This is similar to the segregation acknowledgement letter received by FCMs from their custodial banks, as noted above.

RECOMMENDATION #2: Given the recent issues that have arisen with respect to money market funds as well as other investments that are permissible under CFTC Regulation 1.25, the CFTC should review CFTC Regulation 1.25 and U.S. clearing houses should review their respective rules regarding deposits made by their clearing member firms, such as the IEF2 Program at the CME Clearing House, to determine what chang-

es, if any, are now needed to these regulations and programs. In particular, they should codify that any FCM or clearing member firm that invests in money market funds or other permissible investments under CFTC Regulation 1.25 on behalf of their futures customers will be held liable for any losses that may occur from such investments and should consider setting guidelines relating to such investments. For example, one such guideline, a portfolio diversification guideline, may state that no FCM should invest more than a particular percentage of its customer assets in any one money market fund or other permissible investment. Also, the money market funds that can be used for such investments by FCMs should be required to accept redemptions on a daily basis and pay such redemption proceeds within a certain time frame, e.g., 24 hours, with only one exception permitted, that is, to do so would cause the fund to "break the buck".

Good Risk Management Practices

The risk management disciplines applied by FCMs and other participants in the futures industry are another significant source of customer protection. To provide the greatest protection to its futures customers, the FCM must exercise a strong risk management practice. This requires establishing a proper trade or credit risk amount for each of its client futures accounts, monitoring such levels frequently and receiving current on-going financial information from each futures customer. This is especially true for those customers who trade an account (or a combination of accounts pursuant to an aggregation concept) that results in a large percentage of the open interest of any single commodity being owned or controlled by a client. Also, while a DCO normally sets adequate and proper initial margin levels, typically involving a one day, two standard deviation test, an FCM should also analyze each of its large futures customers, especially those, as noted above, who hold positions that represent a large percentage of the open interest, and apply a more conservative variation risk ("VAR") or standard deviation ("SD") analysis, such as a five day, two SD test, on a daily basis.

If one of the FCM's customers were to fail to meet its margin requirements in a timely manner, which is typically a T+1 standard,²⁰ that FCM would be required to step in and use its own capital to ensure that other customers are not affected and to satisfy that FCM's obligations as a clearing broker. As noted above, most large FCMs maintain a significant amount of their own capital in the customer segregated and secured amount accounts to provide a first line of protection in the event a customer fails to meet its daily margin requirements. Applicable laws and regulations prohibit that FCM from using the assets of its other, non-defaulting futures customers to meet the obligations of a defaulting client. However, as noted above, this does not prevent a clearing house from applying assets held in a clearing member's customer segregated fund account to cover any deficit that may result from a shortfall in the customer segregated account held on the books of that clearing house.

Role of a DCO

DCOs also impose important financial safeguards that are intended to ensure financial safety to the markets. Let's assume, for purposes of this article, that the FCM and its foreign affiliates are a clearing member of most of the major global futures exchanges. The exchange clearing house (referred to in the U.S. as a DCO) stands as the guarantor between its clearing members and represents the buyer and seller of every futures contract ("the buyer to every seller and the seller to every buyer"). As such, the clearing houses establish and enforce strict financial requirements for their clearing members to minimize the likelihood of, and the consequences of, a default by one of the parties to a futures transaction.

In the event of a default by a clearing member, the following resources are typically available to a DCO. First, the exchange memberships and shares held by a defaulting clearing member and all the margin supporting the positions held in its "house" account at the clearing house may be used to cover any shortfall in that clearing member firm's "customer segregated funds" account at the clearing house. Second, each clearing house

requires its clearing members to make deposits to the clearing house's Guaranty Fund, also known as a Surety Fund, to provide additional, back-up capital protections to the clearing house in the event of a customer default. The amount deposited by each clearing member firm typically is based on a formula based on the volume and overnight margin requirements maintained by that clearing member firm. At the CME Clearing House, the Guaranty Fund currently totals approximately US\$1,800,000,000. Third, in the unlikely event that a clearing member were to default and the proceeds held in the Guaranty Fund were used to cover a shortfall, the DCO will immediately take steps to restore its Guaranty Fund to pre-default levels. (For example, the CME Clearing House can require other, non-defaulting clearing member firms to increase their Guaranty Fund deposits by as much as 2.75 times the amount of their security deposits to restore the Fund to pre-default levels.) In its history, no CME clearing member firm has ever defaulted but these safeguards are designed to provide financial protections even in times of significant stress in the financial markets. These protections are further buttressed by the customer margin requirements that are established by the futures exchanges and by the exchanges' own market surveillance and financial surveillance programs, all of which provide important customer protections to futures customers.

Net Capital Requirements

Another customer protection are the financial net capital requirements imposed on all brokerage firms, including FCMs. The minimum "adjusted net capital" requirement, from an accounting perspective, reflects an amount that equals the total of the current liquid assets on the books of the FCM in excess of the total amount of its liabilities. Most large brokerage firms today are registered as both an FCM and as a BD.²¹

Pursuant to CFTC Rule 1.17, the firm must maintain "adjusted net capital" that is equal to or greater than the sum of customer (8%) and non-customer (4%) required margin requirements. In the event that the net capital amount determined pursuant to CFTC Rule 1.17 is greater than the

amount required under SEC Rule 15c3-1, the firm must meet the greater of these two amounts. In determining its minimum net capital requirements pursuant to the applicable regulations noted above, the firm's assets must be valued conservatively, with most financial assets having their value discounted, using value at risk or scenario analysis, to provide a conservative assessment of their market value.

Reporting Requirements

Under applicable rules, a broker-dealer/FCM must provide the SEC, the CFTC, FINRA, the National Futures Association ("NFA") and its designated examining authority and its designated self-regulatory organization (DSRO) (for most large U.S. brokerage firms, this would be FINRA in their broker-dealer capacity and the CME in their FCM capacity) with same-day notice if its regulatory capital drops below the "early warning" level (a multiple of the net capital requirements mandated by SEC Rule 15c3-1 and CFTC Rule 1.17). Similarly, if at any time the firm's regulatory tentative net capital declines by 20% or more from the last month-end, that firm must, in accordance with applicable SEC and CFTC regulations, immediately notify these regulators regarding this change. The "early warning" requirements effectively provide an advance indication of potential financial stress that a broker-dealer/FCM may incur and are set significantly above the level at which a broker-dealer/FCM must maintain its minimum net capital requirements.

The Lehman Events

On September 15, 2008, Lehman Brothers Holdings Inc. ("LB Holdings"), the holding company of all Lehman Brothers entities and the publicly-traded company (NYSE symbol: LEH) filed a petition for bankruptcy under Chapter 11 of Title 11 of the U.S. Bankruptcy Code with the U.S. Bankruptcy Court for the Southern District of New York.²² Its principal U.S. subsidiary, Lehman Brothers Inc. ("LBI"), a registered broker-dealer and FCM, did not file its petition (a Chapter 7 filing) until the following weekend. The principal U.K. affiliate of LB Holdings, Lehman Brothers

International (Europe) ("LBIE"), also submitted its filing on September 15th. The U.K. Financial Services Authority ("FSA") appointed Price Waterhouse Coopers ("PWC") as the Administrator for LBIE. This is similar to the role of a trustee in bankruptcy had LBI made such a filing.

LBI had opened a Customer Omnibus Account on the books of LBIE to permit LBI futures customers to trade on the various European exchanges. LBIE was either directly a general clearing member firm ("GCM") on the clearing houses in Europe, such as LCH Clearnet SA and EUREX Clearing AG, or had established their own customer omnibus accounts on the books of a third party clearing firm on other European exchanges. LBI was the clearing member firm on the U.S. futures exchanges and had opened a futures customer omnibus account with other Lehman Brothers affiliates or third party clearing firms in Canada and Asia. LBIE had opened a customer omnibus account on the books of LBI to allow its futures customers to trade on the U.S., Canadian and Asian markets. All futures customer accounts were opened with either LBI or LBIE.²³ Note that LBIE had many direct futures accounts opened on its books, including some accounts, especially hedge fund accounts, that involved a prime brokerage and cross margin netting arrangement. LBI had similar arrangements with hedge funds on its books but also had a large number of futures-only accounts that were managed by large investment advisory firms.

As noted above, the concept of segregated funds is designed to protect the cash and collateral deposited by futures customers to margin their futures positions. These regulations do not directly address the actual futures positions themselves. Given the uncertainty of the situation and the volatility in the marketplace, senior Lehman futures officials worked closely with their futures clients and governmental and exchange officials to transfer the client futures positions to other clearing firms in order to provide these customers with a new home that was properly capitalized. This process started immediately after LB Holdings filed its petition for bankruptcy in the U.S. but not so outside the U.S. PWC, as the newly-appointed Administrator, did not permit the trans-

fer of the open futures positions until late in the day on Wednesday, September 17th, with the vast majority of the futures positions being transferred on Thursday, September 18th or Friday, September 19th.

Most of the futures positions held by Lehman's customers, whether they were held on the books of LBI or LBIE, were either moved to other clearing member firms per the instructions of such customers by the close of business on Friday, September 19th, or they became futures customers of Barclays Capital Inc. ("BCI"), the U.S. affiliate of Barclays Bank PLC. BCI acquired all of the remaining futures customer accounts on the books of LBI after the close of business on September 19th. Therefore, the system worked for the most part although, as noted above, quicker action was needed. Through the tremendous efforts of many governmental agencies, SROs, firms, exchanges, clearing houses and clients, the goal of transferring the open futures positions was effectively achieved within five days. This reflects the strong working relationships that exist within the global futures community. No other product area or industry can make a similar claim.

RECOMMENDATION #3: In the future, it is imperative that any trustee in bankruptcy or administrator that is selected should have a strong futures product knowledge and expertise to allow prompt and immediate transfers of futures positions. Granted, in today's marketplace, prime brokerage accounts and corresponding Cross Margin Netting Agreements ("CMNA") play a critical role relating to the required funding of the risk margin amounts that control multiple products, including futures accounts, but many futures accounts are stand alone accounts without any prime brokerage ("PB") or CMNA agreements in place. Accordingly, the margin amounts held in such stand alone accounts will not have been used to finance other related financial transactions and products, such as via a PB or portfolio margining arrangement. All customer omnibus accounts fall within this parameter and must be treated differently than other futures accounts that are highly correlated with other products and PB arrangements. The product expertise for such appointees related to futures is critical, and such

appointees, even if they are only granted certain limited powers over futures accounts, must have a thorough knowledge of the global futures markets. Customer protection is the most important goal, and futures positions need to be moved in a very timely manner, especially during a volatile marketplace.

Sadly, some European and Asian exchanges took a different path to resolving the issue before them. Even though the accounts were labeled as customer omnibus accounts on their books, they chose to simply liquidate the open futures positions and not participate in any position transfers. Such liquidations came with little or no prior notice to Lehman officials. This should never be allowed again.

RECOMMENDATION #4: It is very important that every global exchange recognize the concept of a customer omnibus account or create a special coding on their exchange operational system that can easily identify which positions belong to customers and which positions belong to the clearing member's proprietary traders. Once positions are identified as belonging to a customer of a clearing member or their carrying brokers, these customer positions should not be liquidated but should be allowed to be moved to another firm unless, of course, the client seeks such liquidation. The exchange is protected financially as it can liquidate the clearing firm's proprietary positions and can thus hold these proceeds to protect against a market move in the positions held by the customers or can even issue an increased margin call. To merely liquidate open customer positions promptly without providing alternative approaches to the solution is not an acceptable practice and should not be allowed. This is especially troublesome in today's marketplace as a large number of futures positions are used to hedge against some stock or bond portfolios. By liquidating one leg of these positions, given the market volatility that occurred, some clients incurred even greater damage to their portfolio. Actions taken by an exchange or clearing house to liquidate all customer open positions without first providing an opportunity to have these positions transferred, even if permitted by their rules, should be guarded and not used without greater forethought.

RECOMMENDATION #5: The CFTC and the FSA should consider and establish policies, and perhaps regulations, that require any global futures exchange that holds positions for customers of FCMs in the U.S. or registered investment entities (“RIEs”) in the U.K. to contact the CFTC and the FSA, respectively, before the exchange takes actions to liquidate all customer positions. The CFTC and the FSA could require, via a Memorandum of Understanding (“MOU”), that such exchanges notify them in the event an exchange elects to take actions to liquidate all open customer positions.

RECOMMENDATION #6: Regulations need to be established to provide better customer protections for the actual positions held by futures customers globally. As noted above, current regulations only address the cash and collateral used to margin these positions. However, when major events occur, like they did over the weekend of September 12-14, the resulting market volatility caused significant harm to end users who were not able to liquidate their open positions. Regulations need to establish proper guidelines and procedures that an administrator or trustee in bankruptcy must follow to permit the prompt release of open futures positions that are not part of any PB or other risk-based financing arrangement, and to require the exchanges to act accordingly, all in the best interests of the end users of the global futures markets.

RECOMMENDATION #7: The global futures industry is just one small part of the total investment landscape. Many products in today’s marketplace are intertwined within a total risk portfolio. This reflects the significant growth of prime brokerage globally and the growing concept of portfolio margining. Because different products are so correlated to each other, especially from a risk margin and financing perspective, it is very important that all of these products be treated in a similar manner under new bankruptcy laws and regulations that are clearly now needed. Such laws and regulations must be adopted globally. This requires all of the major countries to meet together to address this global problem. A future with 15 or 20 different sets of laws and regulations is not a very bright one. While uniformity

is not needed, commonality of elements and their corresponding interpretations are. A global set of bankruptcy laws and regulations that relate specifically to the insolvency of global brokerage firms and banks are now needed.

While open futures positions were, for the most part, transferred within the first five days, the cash and collateral used to margin those positions were not timely transferred. While part of the delay resulted from some difficulty in the accounting and trade confirmation processes, some banks simply refused to transfer the amounts held in customer protected accounts in a timely manner. For example, JP Morgan Chase Bank NA, the U.S. bank that held all of the cash and collateral in the LBI Customer Segregated Account, stopped releasing customer funds on Thursday, September 18th and continued this “hold” for many more days. Eventually, it agreed to transfer the cash and collateral held in the Customer Segregated Account.

RECOMMENDATION #8: Actions taken by banks that did not release funds in a timely manner were unacceptable.²⁴ There is no probable cause to place a “hold” by such banks on segregated funds. Such banks have signed a “segregated acknowledgement” letter, which clearly states that the bank acknowledges and agrees that the amounts held in a Customer Segregated Account belong solely to the futures customers of the respective FCM and do not belong to any creditors of that FCM or custodial bank. By taking such actions, banks required the end users, in essence, to “double segregate” by depositing new margin amounts at their new clearing firms. The additional funding requirement adversely impacted their liquidity performance and return and should not have occurred.

RECOMMENDATION #9: The CFTC, NFA, FSA and the respective clearing houses should carefully review the entire process of account movement during stressed situations, establish proper guidelines and procedures to require custodial banks, that act in this capacity on behalf of futures customers on a global basis, to transfer customer protected funds in a very timely manner and take enforcement actions against banks that refuse to act in the best interests of the customers.

PWC, the Administrator for LBIE, issued a statement on October 7, 2008, stating it was still reviewing how to deal with requests for transfer of client monies and assets. PWC gave no indication as to when such client assets would be distributed. Other firms appointed to serve as the trustee in bankruptcy in other jurisdictions have also not released any of the funds held in the LBI Customer Omnibus Account on the books of LBIE and other non-U.S. Lehman affiliates. In Japan, for example, the bankruptcy-appointed firm indicated that it would not announce any decision regarding releasing the funds held in LBI's customer segregated account until after November 17, 2008.

RECOMMENDATION #10: As noted above, the customer omnibus account of a U.S. FCM should receive prompt payment of any amounts held in such accounts in those countries that the CFTC deem to be a good control location over customer funds, once the open positions have been transferred to another clearing member. The CFTC, together with the industry and other foreign governmental agencies, need to review these procedures and establish new guidelines on how such omnibus accounts should be treated. Once the open positions held in a customer omnibus account have been transferred away, then the funds held to margin those positions should be promptly transferred back to such customers or their new clearing member firms.

RECOMMENDATION #11: Customer funds held by a brokerage firm or exchange in a country that is deemed to be a good secured location pursuant to CFTC regulations should not be deemed to be subject to the claims of a creditor of the brokerage firm that has filed for bankruptcy and should be protected against such claims. The CFTC should consider whether a non-US exchange, that permits a U.S. FCM to open a customer omnibus account on the books of a clearing member firm of that exchange, should be required to open special bank accounts with a U.S. bank or DCO to hold such initial margin within the U.S. and be subject to the U.S. Bankruptcy Code and Part 190 of the CFTC Regulations in order to facilitate the transfer of such customer funds in a timely manner.

RECOMMENDATION #12: The CFTC and the NFA, together with other governments and industry associations, should establish a task force that includes members from the industry and the end user community to determine what new best practices are now needed in the event such a global bankruptcy event ever occurs again. The last such industry task force was established after the *Barings* collapse in the mid-1990s. There has been considerable change in the way the industry operates since then, in particular the wide-spread use of PB arrangements and new risk management analyses for funding a wide array of financial products. The new task force should consist of a global committee that creates several sub-committees, each having jurisdiction and responsibility over a specific issue or concern.

RECOMMENDATION #13: The current caps on FDIC insurance (currently, \$100,000)²⁵ and SIPC (\$500,000) are being reviewed for possible increases. The futures industry and the CFTC should meet to determine whether an insurance program is now needed for futures accounts. SIPC specifically excludes futures accounts. However, in light of the actions taken by some of the global exchanges in connection with Lehman's bankruptcy, there is a need to determine whether such an insurance program is now viable and can be properly funded.

Conclusion

As noted above, the process and procedures that followed the filing of Lehman's bankruptcy did not always flow as well as many believed it should have. The industry and government need to establish a task force that addresses these issues and determine what changes and best practices, if any, are now needed to minimize the impact on customers in the event another such bankruptcy ever occurs.

NOTES

1. 2008, Ronald H. Filler. Printed with permission. "CFTC" stands for the U.S. Commodity Futures Trading Commission, the U.S. governmental agency in charge of regulating the U.S. futures markets and U.S. industry professionals.

2. Special recognition goes to Acting CFTC Chairman Walt Lukken, NFA President Dan Roth and many other senior CFTC and NFA staff members who provided tremendous assistance to help the futures customers of Lehman Brothers Inc. throughout this period.
3. Another FCM has recently been the subject of bankruptcy proceedings. See Sentinel Management Group, Inc. (U.S. Bankruptcy Court for the Northern District of Illinois, Eastern Division (Case No. 07 B 14987) but this proceeding involved a different set of issues and did not involve transactions in futures contracts. Bear was taken over by J.P. Morgan Bank, with the assistance of the Federal Reserve Bank, in March 2008.
4. A broker-dealer must maintain its securities customer assets in compliance with the SEC's "customer protection rule" (Rule 15c3-3), including maintaining cash in a special reserve account and maintaining fully paid and excess margin securities in a segregated account. In general, the securities accounts maintained at a BD will receive the benefit of expedited administration and the right to recover up to US\$100,000 in cash or US\$500,000 in securities if its broker-dealer were to become insolvent. Under such a scenario, customer assets held in a securities account would be administered pursuant to a proceeding brought by the Securities Investor Protection Corporation (SIPC) pursuant to the Securities Investor Protection Act (SIPA). If the BD were also registered as an FCM, futures customers should understand, however, that SIPA rules specifically exclude futures customer accounts and their assets from its provisions. Most BDs have purchased a surety bond that provides protection in excess of the amounts provided under SIPC. However, this surety bond would, like SIPA, be limited to only the broker-dealer securities accounts and would not apply to the futures customer assets held by a joint BD-FCM.
5. 7 U.S.C. § 1 et seq.
6. See CFTC Regulations 1.20 and 30.7
7. 7 U.S.C. § 6d(a)(2)
8. "Good control location" is mainly a term used by broker-dealers pursuant to SEC regulations but its meaning here implies an account established in accordance with CFTC regulations.
9. See Interpretative Statement issued by the CFTC on September 26, 2008, regarding funds related to cleared-only contracts.
10. For those jurisdictions (e.g., Germany, Hong Kong, Korea) that do not provide the standard customer asset protection that requires the separation of a Firm's proprietary assets from its customer assets, the FCM may deposit a corresponding amount of its own capital in a good control location, typically in the accounts at its respective custodial bank, to reflect the amounts as determined in its 30.7 daily secured amount calculation (based on the amount for that trade date), in its UK FSA segregation daily calculation (based on the amount as determined on the trade date plus one day) and in its weekly 15c3-3 weekly calculation. This form of "double segregation" provides significant protections to an FCM's futures customers.
11. Note that, pursuant to applicable CFTC regulations, an FCM is required to deposit all customer cash and securities in a customer segregated fund account but, in reality, is not required to place customer assets in a secured amount account. It can elect to use its own capital to meet the minimum secured amount requirements.
12. If the FCM is also registered as a broker-dealer, then these non-regulated accounts are maintained in accordance with SEC Rule 15c3-3. The Customer Reserve Formula calculation required by SEC Rule 15c3-3 is performed weekly, typically on each Monday reflecting the amounts as of the previous Friday's close of business. The assets held in this account can not be commingled with the FCM's proprietary funds and are maintained in a designated Special Custody Account for the "Exclusive Benefit of Customers" (EBOC Account) at a designated custodial bank.
13. See Note 4, *supra*.
14. See CFTC Regulation 1.20 which states in essence: "All customer funds shall be separately accounted for and segregated as belonging to commodity or option customers. Such customer funds when deposited with any bank, trust company, clearing organization or another futures commission merchant shall be deposited under an account name which clearly identifies them as such and shows that they are segregated as required by the Act and this part." CFTC Regulation 30.7 contains similar language regarding the treatment of foreign futures and options secured amount accounts.
15. See CFTC Regulation 1.17.
16. For a more detailed explanation of applicable laws and regulations affecting the bankruptcy

of an FCM, see Subchapter IV of Chapter 7 of the U.S. Bankruptcy Code and Part 190 of the CFTC Regulations.

17. Pursuant to CFTC Rule 1.25, an FCM may re-hypothecate customer funds provided that, at all times, an equivalent amount of the funds being re-hypothecated are maintained in the customer segregated account.
18. This view has been expressed by many industry observers but is not directly covered by any CFTC regulation.
19. The Reserve Fund "broke the buck" in September 2008, and many other such funds halted redemptions for a 7-day period as permitted by their prospectus. On September 22, 2008, the SEC, pursuant to Section 22(e) of the Investment Company Act of 1940 (the '40 Act") issued an order temporarily suspending redemptions and postponing payment of shares of two series of The Reserve Fund -- The Primary Fund and The U.S. Government Fund. On September 29, 2008, the Board of Trustees of The Reserve Fund announced that it would liquidate the assets of The Primary Fund. (See Release No. 28386). See also CFTC Staff Interpretative Letter issued on September 24, 2008, to Debra Kokal, Chairman of the Joint Audit Committee. Also, on September 29th, the U.S. Treasury Department announced that it was opening its Temporary Guarantee Program for Money Market Funds (Press Release hp-1161). In the release, the Treasury Department stated that it will guarantee the share price of any publicly offered eligible public money market fund that is regulated under SEC Rule 2a-7 under the 1940 Act for amounts held by shareholders as of September 19th.
20. After T+3 days, a capital charge is assessed against the FCM for failing to collect the required margin amount.
21. A few, including Goldman Sachs, Morgan Stanley and Merrill Lynch, were also once licensed as a consolidated supervisory entity ("CSE"). The SEC suspended the CSE program on September 26, 2008. See SEC Release 2008-230. A key protection to customers is the special regime applicable to CSEs under the SEC's and CFTC's respective "net capital" rules (SEC Rule 15c3-1 and CFTC Rule 1.17). As a CSE, the firm would calculate its net capital requirement pursuant to Appendix E to SEC Rule 15c3-1, which establishes alternative net capital requirements and allows the CSE firm to use SEC-approved value at risk or scenario analysis models to calculate and remain in compliance with the SEC and CFTC net capital requirements. The CSE net capital rules effectively require that the CSE firm must maintain at least US \$500 million in "adjusted net capital" and US\$1 billion in "tentative net capital" in order to continue operations. This calculation does not include customer-owned securities.
22. Case No. 08-13555. The petition was filed following a special meeting of the Board of Directors of Holdings on September 14, 2008. On September 19, 2008, LBI filed a proceeding under the Securities Investor Protection Act of 1970 (Case No. 08-01420). See also Statement issued by SIPC on September 15, 2008.
23. Over this same weekend, Merrill Lynch was acquired by the Bank of America and American International Group ("AIG") received a \$85 billion loan from the U.S. Treasury. All of these events and other similar concerns created huge volatility in the global markets all at once. During this same period, many banks refused to issue credit to other financial institutions, including other banks. Over the weekend of September 19-21, 2008, the U.S. Treasury announced its \$700 billion bailout which received Congressional approval on October 3, 2008.
24. Section 4d(b) of the CEA states in essence: "It shall be unlawful for any person, including but not limited to any clearing agency of a contract market or derivatives transaction execution facility and any depository, that has received any money, securities, or property for deposit in a separate account as provided in paragraph 2 of this section, to hold, dispose of, or use any such money, securities, or property as belonging to the depositing futures commission merchant or any person other than customers of such futures commission merchant." 7 U.S.C. § 6d(b).
25. FDIC insurance was increased to \$250,000.00 on a temporary basis through December 2009 pursuant to the Economic Stabilization Act of 2008 passed on October 3, 2008.