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## **Disclosure of LCH Limited (the "Clearing House") – FCM Rulebook**

### **Article 39(7) of Regulation (EU) No. 648/2012 of the European Parliament and the Council of 4 July 2012 ("EU EMIR")**

### **Article 39(7) of Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC Derivatives, Central Counterparties, and Trade Repositories, as it has become retained EU law and effective in the United Kingdom under the European Union (Withdrawal) Act 2018 ("UK EMIR")**

#### **1. Introduction**

The Clearing House operates two clearing models. One clearing model is set out in the Clearing House's English law Rulebook (the "**General Rulebook**"). The second clearing model is only available to futures commission merchants ("**FCMs**") that are registered with the U.S. Commodity Futures Trading Commission ("**CFTC**"). This second clearing model is governed by the Clearing House's FCM rulebook, which comprises the FCM Regulations, the Clearing House's English-law governed Default Rules and the FCM Procedures, as published at [www.lch.com](http://www.lch.com) and amended from time to time (the "**FCM Rulebook**").

This information is provided in accordance with the requirement under article 39(7) of EU EMIR and article 39(7) of UK EMIR (where EU EMIR and UK EMIR are collectively, "**EMIR**") to disclose publicly certain information in relation to the levels of protection and account segregation which it provides (the "**Disclosure Requirement**"). Terms not otherwise defined in this Disclosure Requirement have the meanings ascribed to them in the FCM Rulebook.

This information relates to the model set out in the FCM Rulebook and not to the model set out in the General Rulebook.

As a result of the legal and regulatory regimes applicable to clients and clearing members across different jurisdictions, restrictions may apply as to the type of entity that a client may clear with or a clearing member may clear for. This may impact the level of customer protection and the bankruptcy rules applicable to the relevant clearing model. Clients may be restricted from clearing with non-FCMs based on whether they are a US-person or where the transactions that they enter into are executed. However, other clients may be able to choose to clear through an FCM under the CFTC's regime or through another Clearing Member under the client clearing arrangements governed by EMIR. Clients that clear through an FCM

should be aware that their assets will be subject to the CFTC customer protection rules and in an insolvency of their FCM will be distributed in accordance with US bankruptcy law as further described herein.

Pursuant to the FCM Rulebook, FCMs are required to make EMIR OSA Segregation (as defined below) and EMIR ISA Segregation (as defined below) available to those clients that are able to accept it. As FCMs are only able to offer LSOC Account Segregation and Futures Segregation (as defined below), they must make EMIR OSA Segregation and EMIR ISA Segregation available to eligible clients through another Clearing Member.

## 2. Account Arrangements – Segregation

### 2.1. *The segregation principle*

Under Article 39(2) and Article 39(3), respectively, of EMIR, a CCP is required to offer omnibus client segregation and individual client segregation. The Clearing House does this through four broad types of account - Omnibus Segregated Accounts (**EMIR OSA Segregation**) which provide omnibus client segregation, Individual Segregated Accounts (**EMIR ISA Segregation**), Custodial Segregated Accounts (**EMIR CSA Segregation**) and Indirect Gross Accounts (**EMIR IGA Segregation**), which each provide individual client segregation. Those accounts are governed by the General Rulebook. Information in relation to the levels of protection and account segregation provided by EMIR OSA Segregation, EMIR ISA Segregation, EMIR CSA Segregation and EMIR IGA Segregation can be found at [insert link].

The Clearing House also offers two additional account types – "**LSOC Account Segregation**" ("legally segregated, operationally commingled" accounts complying with the requirements of the CFTC Regulations) and "**Futures Segregation**" (an omnibus style account offered to FCMs complying with CFTC Regulations) to FCMs through the FCM Rulebook.

### 2.2. *Segregation of client positions and collateral from house positions and collateral*

The following requirements apply under both the LSOC Account Segregation and Futures Segregation models:

- (1) each FCM is required to identify to the Clearing House whether positions have been entered into on behalf of a client or for the account of the FCM as well as whether the funds posted to the Clearing House relate to the FCM's client or proprietary positions;
- (2) client positions and collateral held or maintained by the Clearing House on behalf of the FCM's clients are segregated from the FCM's and the Clearing House's proprietary/house positions and collateral; and
- (3) the Clearing House may not use funds or collateral value attributable to the FCM's client accounts to satisfy a payment obligation related to any FCM's proprietary position.

### 2.3. *Segregation arrangements as between clients*

Under both the LSOC Account Segregation and Futures Segregation models the FCM is permitted to operationally commingle collateral belonging to its clients in an omnibus account at the Clearing House, separated based on the category of product cleared. The primary difference in respect of segregation arrangements as between clients under the LSOC Account Segregation and Futures Segregation models is the Clearing House's treatment and legal segregation of the initial margin posted by the FCM to the Clearing House in connection with client positions.

Under the LSOC Account Segregation model, the Clearing House calculates both the initial and variation margin requirements for client positions, and the FCMs post the initial margin amounts related to client positions to the Clearing House, on a gross basis. As a result, under the LSOC Account Segregation model, the Clearing House will not use a swaps client's initial margin posted by the FCM or variation settlement gains of any client of an FCM to satisfy a payment obligation of the FCM with respect to a position of any other client, and the value of collateral delivered in respect of initial margin requirements in respect of a swaps client can only be used to cover losses relating to that client's swaps positions (except as provided in Section 2.1.17(f) of the FCM Procedures, in respect of the FCM SwapClear service, and Section 2.2.26(f) of the FCM Procedures, in respect of the FCM ForexClear service)<sup>1</sup>. This applies both in the event of an FCM's insolvency and otherwise.

In contrast, under the Futures Segregation model, the Clearing House calculates the initial and variation settlement requirements for the FCM's client futures contracts, and the FCM posts the initial margin amounts related to client futures positions to the Clearing House, on a gross basis with respect to each client's futures positions. Under the Futures Segregation model, in an event of a payment default by the FCM to the Clearing House, the Clearing House is permitted to use initial margin funds and variation settlement gains held in an omnibus account at the Clearing House on behalf of all futures clients of that FCM (including the value of the related collateral) to meet the net payment obligation related to the FCM's client futures positions (including the use of any client gains to meet client losses), without regard to which futures clients gained or lost, or which futures clients defaulted or made full payment. Unlike the LSOC Account Segregation model, the Futures Segregation model does not provide any protection from the "fellow customer risk" and only provides protection from losses attributable to an FCM's house account.

The LSOC Account Segregation and Futures Segregation models both rely on the maintenance of a book-keeping account with the Clearing House and the holding of client collateral at a "Permitted Depository" (i.e. a depository which is permitted to hold client collateral pursuant to CFTC Regulations). The purpose and functions of these accounts are summarised below.

#### *Clearing House Accounts – Swaps*

##### (a) **FCM Omnibus Swaps Client Account with LCH**

Each FCM is required to open an FCM Omnibus Swaps Client Account with LCH on behalf of all its swaps clients in a particular business category (i.e. separate accounts are required to be opened in respect of the FCM SwapClear Service and the FCM ForexClear Service).

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<sup>1</sup> In the event of an FCM's insolvency, clients may be subject to the sharing of pro-rata losses where there is a shortfall in the swaps account. This is further described below.

<sup>2</sup> The interplay between the LSOC rules and the FCM insolvency provisions under the Bankruptcy Code and the Part 190 Rules has yet to be tested in practice.

An FCM Omnibus Swaps Client Account with LCH is a book-entry account that records the contracts entered into on behalf of clients and the value of the associated collateral. The records of the Clearing House in relation to the positions of clients and the value of collateral covering such positions are based solely on the information provided by the relevant FCM.

(b) **FCM Client Sub-Accounts**

Each FCM is required to open an FCM Client Sub-Account (a sub-account of the relevant FCM Omnibus Swaps Client Account with LCH) in the name and on behalf of each swaps client.

FCM Client Sub-Accounts are book-entry sub-accounts that record the contracts entered into on behalf of the specific client and the value of the collateral that is attributable to such sub-account.

*Without Excess and With Excess Models*

The Clearing House operates two margining models. The default model is the "Without Excess Model". An alternative model – the "With Excess Model" – is available to FCMs who have been approved by the Clearing House to operate the With Excess Model. Under both the Without Excess Model and the With Excess Model, the records of the Clearing House in relation to the positions of swaps clients and the value of collateral attributable to such sub-account are based solely on the information provided to the Clearing House by the relevant FCM<sup>3</sup>.

Under the Without Excess Model there is no ability to hold or attribute a collateral value in excess of the margin requirement in respect of the contracts recorded to a sub-account of an individual client<sup>4</sup>. Accordingly, under the Without Excess Model the value of collateral attributable to the relevant sub-account will be the amount required to meet the margin obligations in respect of the contracts recorded to an account and at the end of each day any collateral value in excess of the required margin value will be recorded in an Unallocated Excess Sub-Account – a sub-account of the relevant FCM Omnibus Swaps Client Account with LCH – held for the benefit of all the clients in that FCM Omnibus Swaps Client Account with LCH and unavailable to the Clearing House in the event of an FCM default.

The With Excess Model enables an FCM to attribute and record collateral value in an FCM Client Sub-Account, in excess of the margin requirement in respect of the contracts recorded in that account. Under the With Excess Model, the value of the collateral recorded to the relevant FCM Client Sub-Account will therefore be the value of the collateral supporting the contracts recorded in the sub-account (i.e. the margin requirement) plus any excess collateral value allocated to that sub-account.

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<sup>3</sup> Other than where certain assumed allocations are made by the Clearing House based on margin changes and other events.

<sup>4</sup> Excess may arise on a sub-account intra-day as a result of re-valuing collateral or changes in margin requirements.

### *Clearing House Accounts - Futures*

The Clearing House will open an FCM Omnibus Futures Client Account with LCH for each FCM on behalf of its futures clients.

An FCM Omnibus Futures Client Account with LCH is a book-entry account that records the contracts entered into on behalf of clients and the value of the associated collateral. The records of the Clearing House in relation to the positions of clients and the value of collateral covering such positions are based solely on the information provided by the relevant FCM.

Collateral received from an individual FCM on behalf of its futures clients is held on behalf of those clients as a class and may not be used to margin the FCM's proprietary positions, positions of the FCM's clients in other products or positions of clients of any other FCM. The Futures Segregation model does not contemplate sub-accounts.

### *LCH Client Segregated Depository Account*

The Clearing House maintains all funds posted by the FCM to the Clearing House in connection with client contracts, separately for each contract category (i.e. client collateral would be maintained separately with respect to each product offered at the Clearing House), and all monies accruing in respect of such contracts in an LCH Client Segregated Depository Account maintained with one or more Permitted Depositories.

The assets deposited in such accounts will represent collateral delivered by all FCMs on behalf of their clients and are held on a commingled basis. However, the value of such collateral assets attributable to an individual client will be indicated in the relevant FCM Client Sub-Account held on behalf of the relevant client for the LSOC Segregation model. For Futures Segregation, collateral value is recorded on an omnibus basis.

### **3. Insolvency Law – Default and Porting**

An FCM would be subject to a liquidation proceeding pursuant to Subchapter IV of Chapter 7 of the US Bankruptcy Code (the “Bankruptcy Code”) (and also Part 190 of the CFTC rules (the “Part 190 Rules”) which implement such provisions). Such a proceeding would result in the appointment of a trustee who would, among other things, take control of the FCM’s business, be responsible for liquidating the FCM’s assets and be responsible for evaluating claims of creditors against the FCM’s estate.<sup>5</sup> A central goal of this regime is to transfer most commodity customer accounts prior to, or at the outset of, a proceeding. Indeed, if the bankruptcy occurs, the Part 190 Rules require (and the Bankruptcy Code permits) that the bankruptcy trustee use its best efforts to effect a transfer of open commodity contracts (which would include cleared swaps) to another FCM.<sup>6</sup> The transfer of open contracts may also be

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<sup>5</sup> If the FCM is also a broker dealer insured by the Securities Investor Protection Corporation (“SIPC”), the provisions of the Securities Investor Protection Act of 1970 (“SIPA”) would apply to the liquidation of a joint broker dealer/FCM. SIPA provides that a SIPC trustee appointed for a joint BD/FCM debtor has the duties of both a trustee under SIPA and a bankruptcy trustee under subchapter IV of chapter VII of the Bankruptcy Code, but only to the extent consistent with SIPA. SIPC and the CFTC have yet to develop a common framework for dealing with joint broker-dealer and FCM insolvencies, resulting in a potential for conflict between the provisions of SIPA and the FCM insolvency provisions. However, in recent large joint broker dealer FCM insolvencies such as Lehman Brothers Inc. and MF Global, conflicts between SIPA and the FCM insolvency provisions were not readily apparent.

<sup>6</sup> The Part 190 Rules provide that certain types of accounts, including house accounts and accounts that are in deficit, are generally not eligible for transfer.

accompanied by a transfer of collateral. The amount of collateral being transferred will be determined by the trustee in bankruptcy and will be subject to approval by the Bankruptcy Court. It is conceivable that not all collateral will transfer with open contracts, in which case the receiving FCM may make a margin call on the customer whose account is transferred.

In the event the FCM accounts are not transferred to another FCM, the accounts are liquidated and “customers” (as such term is defined in the Bankruptcy Code and the Part 190 Rules) are entitled to receive distributions on a *pro rata* basis out of “customer property” allocable to a particular account class to the extent of their “net equity.”<sup>7</sup> The Part 190 Rules contemplate six potential types of commodity account classes, including assets held for customers trading on domestic exchanges, customers trading on foreign exchanges and customers trading cleared swaps. Under the Part 190 Rules, “non-public customers” (including the FCM clearing for itself) are not entitled to a distribution from the “customer property”<sup>8</sup> pool until the “net equity” claims of “public customers” (generally non-affiliated customers of an FCM) are satisfied in full. A claim not satisfied out of “customer property” (including a customer claim where there is a “customer property” shortfall e.g. because the value of collateral that comprises such customer property has fallen) is treated as a general creditor claim subject to the priorities of section 726 of the Bankruptcy Code. The Bankruptcy Code and the Part 190 Rules provide for special protections to those “customers”<sup>9</sup> holding “net equity” claims in respect of “specifically identifiable property”.<sup>10</sup> Those protections enable customers, subject to certain exceptions, to instruct the bankruptcy trustee to transfer or return any “specifically identifiable property,” up to the funded portion of their net equity claim from their *pro rata* share of the applicable account class’s share of “customer property.” To the extent the value of the customer’s “specifically identifiable property” which is not margining an open contract exceeds the estimated funded portion of the customer’s “net equity” claim, the customer may obtain such property by providing the bankruptcy trustee with cash for the unfunded portion. All distributions of customer property are made via the trustee, rather than directly from the Clearing House.

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<sup>7</sup> “Net equity” under Subchapter IV of Chapter 7 of the Bankruptcy Code generally means the net value of the commodity positions and margin in the customer’s account. For the LSOC Account Segregation model, where positions may be hedged and liquidated on an aggregate basis, the provisions of Section 2.1.17(f) of the FCM Procedures, in respect of the FCM SwapClear service, and Section 2.2.26(f) of the FCM Procedures, in respect of the FCM ForexClear service, are relevant in determining the “net equity” of each “customer”.

<sup>8</sup> “Customer Property” under Subchapter IV of Chapter 7 of the Bankruptcy Code includes cash, a security or other property, or proceeds of such cash, security or property, received, acquired or held by or for the account of the debtor, from or for the account of the customer, including, *inter alia*, (i) cash, securities and other property of a customer held to margin, guarantee, secure, purchase or sell a commodity contract, (ii) open commodity contracts, and (iii) specifically identifiable property.

<sup>9</sup> “Customer” under Subchapter IV of Chapter 7 of the Bankruptcy Code includes certain entities with a claim against an FCM on account of, among other things: (i) commodity futures traded on or subject to the rules of a contract market or board of trade; (ii) commodity options; (iii) any other agreement or transaction that is similar to the foregoing; and (iv) swaps cleared through a derivatives clearing organization.

<sup>10</sup> “Specifically identifiable property” under the Part 190 Rules includes, among other things, the following: (i) customer margin consisting of certain securities registered in the customer’s name and certain warehouse receipts, bills of lading or other documents of title held for the customer’s account; (ii) certain open commodity contracts entered into as hedges pursuant to the Commodity Exchange Act in customer accounts designated as hedge accounts; and (iii) cash or other property received from a customer in the three days prior to the initiation of proceedings for the purpose of settling certain commodity futures or options.