

## DCO INSOLVENCIES— RETAIL CUSTOMER ISSUES

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### I. INTRODUCTION

Several market participants are considering direct (or non-intermediated) clearing models, in which a derivatives clearing organization (DCO) will interface directly with retail customers. U.S. government agencies, members of Congress and other government officials also are considering legislation to regulate cryptocurrencies and their marketplaces in the wake of the bankruptcies of *FTX*, *BlockFi*, *Celsius*, *Voyager* and other cryptocurrency market participants. Some of these proposals contemplate that cryptocurrency exchanges which interface directly with retail customers would be registered as DCOs, and that subchapter IV of chapter 7 of the Bankruptcy Code (governing the liquidation of commodity brokers) and the Part 190 rules promulgated by the Commodity Futures Trading Commission (CFTC or Commission) would apply in the event of a cryptocurrency exchange or cryptocurrency clearing organization bankruptcy.

To evaluate these proposals, a basic understanding is needed of the Commis-

sion's Part 190 bankruptcy rules and how those rules would apply in the event of a DCO bankruptcy. This article provides a general overview of the Commission rules currently applicable to a DCO bankruptcy, and explains some of the practical reasons why the existing rules may need significant revisions to accommodate either direct clearing or the registration of cryptocurrency exchanges as DCOs.

### II. CURRENT RULES

#### A. OVERVIEW

A commodity broker (which under the current regulatory scheme could be either a DCO or a futures commission merchant (FCM)) is not eligible to file a restructuring bankruptcy case under chapter 11.<sup>1</sup> A commodity broker may only file for liquidation, and must do so under a special subchapter of chapter 7 of the Bankruptcy Code, subchapter IV (Subchapter IV).<sup>2</sup> Because Subchapter IV is a liquidation proceeding, bankruptcy is generally considered to be the last resort for a commodity broker resolution.

Although several FCMs have failed since the enactment of the modern Bankruptcy Code in 1978, there has never been a DCO failure under Subchapter IV. Thus, the steps that can be taken during a DCO insolvency proceeding to prevent market disruption and make prompt customer distributions (whether under Subchapter

IV, Title II of the Dodd-Frank Act,<sup>3</sup> or otherwise) are theoretical and untested.

The Commission has relatively broad authority to promulgate regulations applicable in a Subchapter IV bankruptcy case, which it has done at Part 190 of its rules.<sup>4</sup> For more than four decades, the Part 190 rules did not include detailed rules applicable to a DCO bankruptcy case. That changed in 2021, when the Commission for the first time promulgated detailed rules applicable in a DCO bankruptcy. These DCO-only rules applicable in Subchapter IV cases are found at subpart C of the Part 190 rules, consisting of Commission Rules 190.11 through 190.19 (Subpart C).<sup>5</sup>

If the DCO is organized outside the United States and is the subject of a foreign proceeding, only limited provisions of Subpart C apply, namely Rule 190.12 (notices, reports and records), Rule 190.13 (bankruptcy safe harbor against clawbacks, but only with respect to futures contracts and cleared swaps contracts cleared for FCM clearing members on behalf of their public customers), and Rules 190.17 and 190.18 (calculation of net equity and distribution of property, but only with respect to claims of FCM clearing members on behalf of public customers, property that is or should have been segregated for the benefit of FCM clearing members' public customers, and property that has been recovered for the benefit of FCM clearing members' public customers).<sup>6</sup>

## B. POST-BANKRUPTCY OPERATION OF A DCO

In a Subchapter IV case, existing management is displaced by a bankruptcy trustee selected by the U.S. Trustee for the region. The Bankruptcy

Code requires that the bankruptcy trustee be a member of the panel of private trustees who generally serve as bankruptcy trustees in consumer chapter 7 cases.<sup>7</sup> Most panel bankruptcy trustees are not familiar with commodity broker liquidations or the Part 190 rules, and thus depending on the jurisdiction in which the case is filed and the experience of the trustee and their counsel, there could be a steep learning curve for the trustee.

Although the Part 190 rules generally reflect a strong preference for the porting of customer accounts and property to other commodity brokers when possible, Subpart C recognizes that account and contract porting may not be feasible in a DCO bankruptcy case. Unless another DCO agrees to take over the failed DCO's operations or the DCO is subject to resolution under Title II of the Dodd-Frank Act, the likely outcome of a DCO bankruptcy case is liquidation and the distribution of proceeds (as opposed to a transfer) of customer property.

In contrast to the Part 190 rules governing the bankruptcy liquidation of an FCM, the Subpart C rules do not prescribe the manner in which a DCO will be wound down and liquidated by the bankruptcy trustee. The Part 190 rules instead require the bankruptcy trustee to implement, in consultation with the Commission, the DCO's default rules and procedures prepared under Commission Rule 39.16 and (if applicable) Commission Rule 39.35, as well as any termination, close-out and liquidation procedures included in the rules of the DCO.<sup>8</sup> The application of these rules and procedures is subject to the bankruptcy trustee's reasonable discretion, and also is limited to circumstances where implementation of the DCO's default rules and procedures is practicable.

The Part 190 rules also requires the bankruptcy trustee, in consultation with the Commission, to take actions in accordance with the DCO's recovery and wind-down plans, to the extent reasonable and practicable, that have been filed pursuant to Commission Rule 39.39.<sup>9</sup> A DCO's recovery and wind-down plans filed under Commission Rule 39.39 typically are not publicly available.

The Commission originally proposed that Subpart C would give the bankruptcy trustee a short six-day window of opportunity within which to continue operating the DCO (with the Commission's permission), so as to improve the chances of resolution under Title II of the Dodd-Frank Act or the transfer of clearing operations to another DCO. However, following a number of public comments expressing concern that the proposed rule would create legal uncertainty concerning the DCO's close-out netting rules and undermine netting treatment under bank capital rules for bank-affiliated clearing members, the Commission withdrew that proposal.<sup>10</sup> Thus, there does not appear to be any opportunity to operate a DCO in bankruptcy, even for a limited period of time.

### C. LIQUIDATION OF DCO CUSTOMER PROPERTY

Subchapter IV contemplates the liquidation of DCO customer property if a return or transfer of the property cannot take place.<sup>11</sup> As noted above, unless another DCO immediately agrees to take over the DCO's operations or the DCO is subject to resolution under Title II of the Dodd-Frank Act, the likely outcome of a Subpart C DCO bankruptcy case is liquidation.

The Part 190 rules require a DCO to cease

making variation and initial margin calls upon its bankruptcy.<sup>12</sup> The rules further provide that the bankruptcy trustee must liquidate, no later than seven calendar days after the order for relief, all open commodity contracts that are not yet terminated, liquidated, or transferred.<sup>13</sup> The Part 190 rules require the trustee to conduct the liquidation in accordance with the rules and procedures of the DCO, to the extent applicable and practicable.

The Commission originally proposed that the Part 190 rules would not require the immediate liquidation of all commodity contracts if the Commission (whether at the request of the bankruptcy trustee or *sua sponte*) determined that liquidation would be inconsistent with the avoidance of systemic risk or, in the judgment of the Commission, would not be in the best interests of the DCO's bankruptcy estate. However, the Commission withdrew this proposal in response to public rule comments,<sup>14</sup> and therefore the bankruptcy trustee does not appear to enjoy any discretion to delay the liquidation of commodity contracts even if their liquidation may not be in the best interests of the DCO's bankruptcy estate and its stakeholders.

The Part 190 rules contemplate the liquidation of all customer property to cash.<sup>15</sup> However, the rules do permit the bankruptcy trustee to make distributions to members in the form of securities that are equivalent (*i.e.*, of the same class and series) to those that were originally delivered to the DCO by the member or its customers.<sup>16</sup>

### D. DCO CUSTOMERS AND CUSTOMER PROPERTY

Subsections (g), (i) and (j) of section 766 of the Bankruptcy Code govern distributions to

DCO customers. Subsection (g) provides that in a DCO bankruptcy case, distributions of customer property may be made only in accordance with subsection (i), which governs the distribution of customer property of a DCO.<sup>17</sup> Subsection (j) provides that any deficiency claims of customers are entitled to *pro rata* distributions with general unsecured creditors.<sup>18</sup>

## 1. Customer

The term “customer” has a different meaning in the context of a DCO bankruptcy than it does in an FCM bankruptcy case. Because DCOs traditionally deal only with their own members and do not interface directly with their clearing members’ customers, in a DCO bankruptcy a “customer” means a DCO member that holds a claim against the DCO on account of property transferred to the DCO to margin, guarantee or secure a commodity contract (*i.e.* the DCO’s clearing members).

Two separate customer classes are created in a DCO bankruptcy case. With respect to a DCO, the Part 190 rules define “public customer” as any customer that is not a non-public customer.<sup>19</sup> A “non-public customer” is any person whose account (1) at an FCM that is a member of the DCO is classified as a proprietary account or cleared swaps proprietary account, or (2) at a foreign broker is treated as proprietary account under the DCO’s rules or the jurisdiction of incorporation of the foreign broker.<sup>20</sup>

## 2. Allocation of Customer Property

DCOs are required to segregate the property of public customers of its members from the member’s own property at the DCO. Subchapter IV requires that each clearing member’s proprietary accounts must be treated separately from the

member’s customer accounts at the DCO.<sup>21</sup> The Part 190 rules recognize this distinction by allocating customer property of a DCO’s bankruptcy estate between “member property” and “customer property other than member property.”<sup>22</sup> Member property includes the member’s own property and accounts, as well as property associated with any proprietary accounts, foreign futures and options proprietary accounts, and cleared swaps proprietary accounts of the member’s customers.<sup>23</sup> Allocation to non-member customer property (*i.e.* to public customers) is favored over allocation to member property if there is a shortfall in any public customer account class. Specifically, excess property in any house account class is allocated first to “customer property other than member property” to the extent that any public customer account class is not fully funded, with any remaining excess allocated to member’s house accounts.<sup>24</sup> Excess property in any customer account class similarly is first allocated to “customer property other than member property” if all public customer account classes are not fully funded.<sup>25</sup>

As in an FCM bankruptcy case, the Part 190 rules provide that when customer property is segregated for or traceable to a specific account class, the property must be allocated to that account class.<sup>26</sup> The rules further provide that customer property that cannot be traced to a specific account class is allocated using the same “lowest funded class first” methodology used in an FCM bankruptcy case.

Included within the scope of DCO customer property is any guarantee fund deposit, assessment or similar payment or deposit made by a member to the extent any remains following implementation of the debtor’s default rules and

procedures.<sup>27</sup> DCO customer property also includes any other property of a member that, pursuant to the DCO's rules and procedures, is available to satisfy claims made by or on behalf of public customers of a member,<sup>28</sup> as well the DCO's own assets that were committed as part of its loss allocation rules, to the extent not already applied under its rules.<sup>29</sup>

The Bankruptcy Code provides that the claims of customers and members generally have priority over all expenses of administration and other priority claims.<sup>30</sup> Only administrative expenses attributable to the administration of customer property are given priority over claims arising from customer accounts.<sup>31</sup> Claims that are attributable to the administration of either "member property" or customer property have priority over members' allowed net equity claims.<sup>32</sup> The cost of administering both customer and member property are therefore borne by the DCO's members. General administrative expenses of the DCO liquidation do not have priority over the allowed claims of members or customers.

### 3. Net Equity

The Bankruptcy Code requires the DCO trustee to ratably distribute customer property (other than member property) to members for the benefit of their public customers based on their allowed net equity claims, and to distribute member property ratably to members based on their allowed net equity claims.<sup>33</sup> The Part 190 rules provide that the calculation of net equity claims, and the related allocation of losses among members and their accounts, is based upon application of the DCO debtor's loss allocation rules and procedures.<sup>34</sup> DCO rules and procedures often allocate member recoveries in reverse

order of the allocation of losses, and therefore the Part 190 rules take those DCO rules and procedures into account and adjust members' net equity claims accordingly.<sup>35</sup>

Subpart C incorporates by reference the extensive net equity calculations set forth in Commission Rule 190.08 applicable in an FCM bankruptcy case, but only to the extent that they apply.<sup>36</sup> Rule 190.08 in turn provides that net equity is determined for each customer by account class (*i.e.*, futures, swaps, foreign futures) held by that customer.<sup>37</sup> Special calculation rules apply when the customer holds accounts in multiple account classes and some have deficit balances, and also with respect to obligations owed to or from a customer that are not required to be included in the customer's account equity computation.<sup>38</sup>

### 4. Funded Balance

The concept of "funded balance" addresses how much property is available to be distributed to customers. The Part 190 rules define "funded balance" in a DCO case as a clearing member's *pro rata* share of member property (for a clearing member's house accounts) or "customer property other than member property" for accounts of the clearing member's public customers.<sup>39</sup> The Subpart C rules incorporate by reference the extensive funded balance calculations provisions set forth in Commission Rule 190.08(c) applicable in FCM bankruptcy cases, but again only to the extent that they apply.<sup>40</sup> The funded balance calculations that would not apply in a DCO case likely include the portions of Commission Rule 190.08(c) relating to the subordination of house and proprietary accounts, as both the Bankruptcy Code and Subpart C contemplate a separate, non-subordinated customer class of member property

consisting of the clearing members' house and proprietary accounts.

#### E. DAILY SETTLEMENT

Subpart C includes special provisions relating to variation settlement payments. Funds received after entry of the order for relief as part of the variation settlement process are to be included in the customer property of the DCO.<sup>41</sup> The Subpart C Rules provide that a bankruptcy DCO must cease making calls for either variation or initial margin,<sup>42</sup> so presumably this rule is intended to apply to variation settlement payments "in transit" on the petition date. Those settlement funds are required to be "promptly" distributed to member and customer accounts entitled to payment as part of that day's settlement process.<sup>43</sup>

Deposits of initial margin are considered property of the account class for which they were deposited. If there is a shortfall in settlement payments received by the DCO, certain property may be used to supplement the amounts available to meet settlement obligations: (i) initial margin held for the account of a member that has defaulted on a daily settlement obligation, subject to certain restrictions; (ii) DCO assets dedicated to such use as part of the DCO's default rules and procedures or its recovery and wind-down plans; (iii) prefunded guarantee or default funds maintained pursuant to the DCO's default rules and procedures; and (iv) payments made by members pursuant to the DCO's default rule assessment powers.<sup>44</sup> The rule further provides that if (as supplemented) there is still a shortfall in settlement payment assets, the settlement funds (as supplemented) are to be allocated *pro rata* to member's house and customer property proportionate to the ratio of total gains in member ac-

counts and customer accounts, respectively, to net gains.<sup>45</sup>

### III. ORDERLY LIQUIDATION AUTHORITY

In the event of a major DCO failure, it is possible that the DCO might be resolved by the FDIC acting as receiver under Title II of the Dodd-Frank Act. Title II of the Dodd-Frank Act, also known as the Orderly Liquidation Authority (OLA), gives the FDIC broad powers to act as receiver for covered financial companies regulated for systemic risk.<sup>46</sup> If a DCO is an affiliate of a systemically important financial institution, or SIFI, it is eligible for designation as a covered subsidiary of a SIFI, and is susceptible to resolution under OLA. A systemically important financial market utility, or SIFMU, also could be resolved in an OLA proceeding.

The FDIC's OLA powers give it resolution tools that are analogous to the tools it can use to resolve a failed bank, including the authority to establish a "bridge" entity to which the DCO's operating assets and property are transferred in order to permit continued operation of the DCO, as well as access to liquidity and backstop funding. Dodd-Frank requires that with respect to any commodity broker for which the FDIC is acting as receiver, the FDIC must make distributions of customer or member property in accordance with and as if such entity were a debtor under Subchapter IV.<sup>47</sup> Thus, even if a DCO is resolved under Title II of Dodd-Frank, the question of how much a customer would be entitled to receive in a DCO liquidation under Subchapter IV and the Part 190 rules remains relevant to customer and member distributions.<sup>48</sup>

#### IV. CURRENT PROPOSALS-KEY CONSIDERATIONS

Various market participants are considering direct clearing models. Legislation also is being considered that would make Subchapter IV applicable to cryptocurrency exchanges or cryptocurrency clearing organizations. Application of the existing Subpart C rules in such a DCO bankruptcy case could raise several issues.

*First*, the Part 190 rules governing a DCO bankruptcy lack the detail and transparency that might be expected in a retail-customer facing insolvency proceeding. Subpart C defers to the recovery and wind-down plans of the DCO, many of which are not publicly available. Subpart C also does not include the detailed claims and noticing procedures that are were carefully considered and enacted with respect to FCM cases. While the existing Subpart C approach is workable for DCOs with a limited number of clearing members, a more prescriptive and granular approach may be desirable in DCO cases involving tens or hundreds of thousands of direct retail customers.

*Second*, the DCO recovery and wind-down plans to which the Part 190 rules defer vary, but typically include recovery or wind-down tools such as partial contract tear-ups, gains haircutting, or even complete tear-ups. Application of the DCO's loss allocation rules and procedures could result in different customer recoveries than would be the case if the customers' net equity claims were calculated and paid as otherwise provided for in the Part 190 rules. Careful consideration should be given to what remedies will be available to retail customers affected by the DCO's loss allocation rules and wind-down tools, including whether changes to accommodate

those considerations should be embodied in DCO wind-down plans or the Part 190 rules.

*Third*, member property deposited with a DCO may not necessarily be segregated. If a DCO deals with both intermediated and direct clearing retail customers, customers clearing on an intermediated basis through an FCM member (whose property is segregated at the DCO) could fare better in a DCO liquidation than direct participants trading the same products. Conversely, if the property shortfall arises in a customer segregated account class, it is possible that direct participants might fare better in a liquidation. These situations also could lead to disputes about whether certain property is member, "other customer" or general estate property, and could delay customer distributions; customer property disputes significantly delayed some of the distributions in cases such as *MF Global*, *Sentinel* and *Peregrine*. Consideration should be given as to whether the Part 190 rules might be modified to place direct and intermediated retail customers on more equal footing in a DCO bankruptcy case.

*Finally*, Subchapter IV is a liquidation-only proceeding. In the event Subchapter IV is made applicable to cryptocurrency exchanges or clearing organizations, consideration should be given in the Part 190 rules to the manner in which cryptocurrency and other digital assets might be liquidated by the trustee, and over what period of time; whether customer claims must be converted to fiat currency claims; at what point(s) in time are the values of customer claims determined; and whether flexibility to make in-kind cryptocurrency distributions should be added.

#### ENDNOTES:

<sup>1</sup>11 U.S.C.A. § 109(d).

<sup>2</sup>11 U.S.C.A. §§ 761-767.

<sup>3</sup>Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd Frank), Pub. L. No. 111-203, 124 Stat. 1376 (2010).

<sup>4</sup>17 C.F.R. §§ 190.00 -190.19.

<sup>5</sup>17 C.F.R. §§ 190.11-190.19.

<sup>6</sup>See 17 C.F.R. § 190.11(b).

<sup>7</sup>11 U.S.C.A. § 701(a).

<sup>8</sup>17 C.F.R. § 190.15(b).

<sup>9</sup>17 C.F.R. § 190.15(c). Commission Rule 39.39 requires a detailed recovery and wind-down plan for any systematically important DCO (SIDCO) and any DCO that has elected to be governed by that rule.

<sup>10</sup>Commodity Fut. Trad. Comm'n, *Bankruptcy Regulations*, 85 Fed. Reg. 60,110 (Sept. 24, 2020).

<sup>11</sup>11 U.S.C.A. §§ 766(e) and (f).

<sup>12</sup>17 C.F.R. § 190.14(b)(1).

<sup>13</sup>17 C.F.R. § 190.14(c)(1).

<sup>14</sup>Commodity Fut. Trad. Comm'n, *Bankruptcy Regulations*, 86 Fed. Reg. 19,324, 19,371 (April 13, 2021).

<sup>15</sup>17 C.F.R. § 190.14.

<sup>16</sup>17 C.F.R. § 190.14(c)(2).

<sup>17</sup>11 U.S.C.A. §§ 766(g) and (i).

<sup>18</sup>17 C.F.R. § 766(j)(2).

<sup>19</sup>17 C.F.R. § 190.01.

<sup>20</sup>Id.

<sup>21</sup>11 U.S.C.A. § 763(b).

<sup>22</sup>17 C.F.R. § 190.18(a).

<sup>23</sup>17 C.F.R. § 190.01.

<sup>24</sup>17 C.F.R. § 190.18(c)(1).

<sup>25</sup>17 C.F.R. § 190.18(c)(2).

<sup>26</sup>17 C.F.R. § 190.18(d).

<sup>27</sup>17 C.F.R. § 190.18(b)(1)(iii).

<sup>28</sup>17 C.F.R. § 190.18(b)(1)(iii).

<sup>29</sup>17 C.F.R. § 190.18(b)(1)(iv).

<sup>30</sup>11 U.S.C.A. § 766(i).

<sup>31</sup>Id.

<sup>32</sup>Id.

<sup>33</sup>11 U.S.C.A. § 766(i).

<sup>34</sup>17 C.F.R. § 190.17(b)(1).

<sup>35</sup>17 C.F.R. § 190.17(b)(2). The rule further provides that if “the debtor’s loss allocation rules and procedures would entitle clearing members to additional payments of cash or other property due to (i) portions of mutualized default resources that are prefunded, or assessed and collected, but in either event not used, or (ii) the debtor’s recoveries on claims against others (including, but not limited to, recoveries on claims against clearing members who have defaulted on their obligations to the debtor), appropriate adjustments shall be made to the net equity claims of the clearing members. . . .”

<sup>36</sup>17 C.F.R. § 190.17(c).

<sup>37</sup>17 C.F.R. § 190.08.

<sup>38</sup>Id.

<sup>39</sup>17 C.F.R. § 190.17(d).

<sup>40</sup>17 C.F.R. § 190.17(d).

<sup>41</sup>17 C.F.R. § 190.19(a).

<sup>42</sup>17 C.F.R. § 190.14(b)(1).

<sup>43</sup>17 C.F.R. § 190.19(a).

<sup>44</sup>17 C.F.R. § 190.19(b)(1).

<sup>45</sup>17 C.F.R. § 190.19(b)(2).

<sup>46</sup>Dodd-Frank, § 203.

<sup>47</sup>Dodd-Frank, § 210(m).

<sup>48</sup>Section 210(a)(7)(B) of Dodd-Frank provides that “a creditor shall, in no event, receive less than the amount that the creditor is entitled to under paragraphs (2) and (3) of subsection (d), as applicable,” and section 210(d)(2) in turn provides that the maximum liability of the FDIC to a creditor is the amount that the creditor would have received if the company had been liquidated under chapter 7 of the Bankruptcy Code.