

More Than a Refresh but Much Less Than A Substantial Overhaul: The CFTC Proposes Comprehensive Amendments to Its Bankruptcy Rules

April 29, 2020

KEY POINTS

- On April 14, the Commodity Futures Trading Commission (CFTC) proposed an extensive set of amendments to its bankruptcy rules (Proposal), which have not been materially amended since the regulations were first adopted in 1983.¹
- While not creating new law, the Proposal formally codifies the CFTC's many interpretations and views over the nearly 40 years since the bankruptcy rules were first adopted and acknowledges the significant changes in communications and recordkeeping practices over that same period of time.
- The comment period for the Proposal expires on July 13, 2020.

Background

The CFTC plays a critical role in the liquidation of a commodity broker under Subchapter IV of chapter 7 of the Bankruptcy Code (Code).² Although Subchapter IV sets out the essential provisions governing the liquidation of a commodity broker in bankruptcy, the CFTC is authorized under section 20 of the Commodity Exchange Act (CEA),³ "notwithstanding the Code," to adopt rules that provide, *inter alia*, that: (1) certain cash, securities, other property, or commodity contracts are to be included in or excluded from customer property or member property; and (2) the method by which the business of such commodity broker is to be conducted or liquidated after the date of the filing of the petition under the Code.

Pursuant to this authority, the CFTC adopted Part 190 of its rules governing the liquidation of commodity brokers. Over the years, certain provisions of the Part 190 rules have been amended to accommodate specific issues or statutory changes. For example, when the CFTC adopted Part 22 of its rules relating to cleared swaps, Part 190 was amended to establish the cleared swaps customer account as a separate account class under the rules. The

¹ 17 CFR Part 190. The Proposal relies in significant part on contributions from the Part 190 Subcommittee of the Business Law Section of the American Bar Association.

² 11 USC §§761-767. A "commodity broker" is defined to include a futures commission merchant (FCM) registered or required to be registered with the CFTC and a derivatives clearing organization (DCO) registered with the CFTC.

³ 7 USC § 24.

bankruptcies of MF Global Inc. in 2011 and Peregrine Financial Group Inc. the following year, however, brought to the fore several significant shortcomings in the rules, which demanded a more thorough evaluation of the rules.

The Proposal

To this end, by unanimous vote, the CFTC proposed a comprehensive refreshing of Part 190 rules, although no materially new concepts were introduced.⁴ Even new subpart C, governing the liquidation of a derivatives clearing organization (DCO), relies in significant part on the default management rules and procedures and recovery and wind-down plans adopted by the relevant DCO in accordance with CFTC Rules 39.16 and 39.39, respectively, and submitted to the CFTC for review.⁵

Many proposed amendments solely reflect the evolution of communications and recordkeeping since 1983. For example, the Proposal would replace the requirement that a trustee provide certain notices to customers of a bankrupt futures commission merchant (FCM) by publication in “a newspaper of general circulation . . . serving the location of each branch office of the commodity broker”⁶ with a more general requirement that the trustee establish and follow procedures “reasonably designed for giving adequate notice to customers.”⁷ The Proposal would further recognize that documents of title, including warehouse receipts and shipping certificates representing physical delivery commodities, are frequently held in electronic form.⁸

More substantively, the Proposal provides a more fulsome roadmap for a trustee appointed to liquidate a commodity broker, which confirms and clarifies the CFTC’s policies and its interpretations of the Part 190 rules that the CFTC has developed, in part, in response to past FCM bankruptcies. The Proposal also seeks to address certain ambiguities that have complicated past bankruptcies and avoid future ambiguities “in order to accomplish better and more reliably the goals of promptly and cost-effectively resolving commodity broker bankruptcies while mitigating systemic risk and protecting the commodity broker’s customers.”

Such a roadmap is critical for any trustee, but, as the CFTC notes, it is particularly important when the trustee may not be familiar with the business of an FCM and may be operating primarily under a different statute. For example, when an FCM is also registered with the Securities and Exchange Commission as a broker-dealer, the trustee will likely be appointed and be guided primarily by the Securities Investors Protection Act (SIPA).⁹ However, SIPA provides that, in the case of broker-dealer that is also an FCM, the trustee “shall be subject to the same duties as a trustee in a case under chapter 7 of title 11” to the extent consistent with SIPA or as otherwise ordered by the court.¹⁰

Similarly, in the event of the resolution of a DCO under orderly liquidation provisions of Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the Federal Deposit Insurance Corporation (FDIC), as receiver for the DCO, must apply the provisions of subchapter IV of chapter 7 of the Code with respect to the distribution of customer property and member property. As the CFTC notes, therefore, “in developing resolution strategies for a DCO while mitigating claims against the FDIC as receiver, it is important to understand what would happen if the DCO was instead liquidated pursuant to chapter 7 of the [Code] (and this part 190).”¹¹

⁴ Two commissioners, Dan Berkovitz and Rostin Behnam, objected, however, to what they considered to be a too short comment period – 90 days – in light on the existent COVID-19 pandemic.

⁵ 17 CFR Sec. 39.16 and 39.39.

⁶ CFTC Rule 190.02(b), 17 CFR § 190.02(b).

⁷ Proposed Rule 190.03.

⁸ Proposed Rule 190.01.

⁹ 15 USC §§ 78aaa-78lll.

¹⁰ 15 USC § 78fff-1(b).

¹¹ An FCM may also be resolved under Title II of the Dodd-Frank Act.

By confirming and clarifying the CFTC's policies and interpretations and addressing ambiguities in its current rules, the Proposal is further designed to enhance legal certainty and protect the Part 190 regulatory regime from successful legal challenge. In his remarks during the CFTC's April 14 virtual meeting on the Proposal, Robert Wasserman, Chief Counsel of the Division of Clearing and Risk, noted the importance of exposing the CFTC's interpretations of Part 190 to public notice and comment, especially in light of the U.S. Supreme Court's decision *Kisor v Wilke* 588 US ___ (2019). This case, although affirming previous decisions affording deference to an agency's interpretation of its own rules, also established a multi-factor test that the interpretation must pass, which effectively narrowed the circumstances in which a court should grant deference. Among other requirements, *Kisor* holds that an interpretation must be the agency's "authoritative or official position" and "in some way implicate its substantive expertise."

To this end, new subpart A demonstrates that Congress has recognized the CFTC's substantive expertise with regard to commodity broker liquidations by vesting the CFTC with specific authority to adopt rules in this regard, "notwithstanding the Code."¹² It further confirms that the rules, policies and interpretation established therein represent the CFTC's authoritative and official position.

Included among such policies and interpretations, proposed Rule 190.00 confirms the CFTC's position, for example, that:

- certain contracts are not "commodity contracts" for purposes of Part 190, including: (1) options on commodities (including swaps that are subject to Part 32 of the CFTC's rules) that are not centrally cleared; (2) forward contracts that are not centrally cleared; (3) security futures contracts that are held in a securities account; (4) retail foreign currency transactions; and (5) retail commodity transactions;
- the rules do not apply to commodity options dealers or leverage transaction merchants, since there are no such dealers at this time;
- public customer positions should be transferred where possible and not liquidated;
- in the context of portfolio margining or cross margining programs, commodity contracts and associated collateral will be treated as part of the account class in which, consistent with CFTC rules, they are held (i.e., the so-called "home field" rule); and
- the delivery provisions of Part 190 are intended (1) to allow deliveries to be completed in accordance with the rules and established practices of the relevant contract market or clearing organization and (2) to favor delivery, where practicable, outside administration of the debtor's estate.¹³

A chart summarizing all of the provisions in the Proposal is set out at the end of this advisory. Select provisions of subpart B, Futures Commission Merchant as Debtor, and subpart C, Derivatives Clearing Organization as Debtor, which may be of particular interest, follow.

Subpart B, Futures Commission Merchant as Debtor

Three proposed rules relating to the scope of customer property stand out.

Letters of credit. The CFTC confirms that letters of credit may be drawn to their full value by a trustee, if necessary, in the event of a shortfall in customer funds. This is not a new requirement; current Rule 190.08(a)(1)(i)(E) provides that the full proceeds of a letter of credit may be included in customer property. However, the Proposal is far more detailed and provides that the trustee may request that a customer deliver substitute customer property with respect to any letter of credit received, acquired or held to margin, guarantee, secure,

¹² CEA § 20, 7 U.S.C. § 24.

¹³ The Proposal acknowledges that deliveries under futures contracts may occur within a customer's segregated funds account, although the preference is for it to transpire within a non-segregated delivery account. Proposed Rule 190.06.

purchase or sell a commodity contract. If a customer fails to provide substitute customer property within a reasonable time specified by the trustee, the trustee may, if the letter of credit has not expired, draw upon the full amount of the letter. The Proposal further provides that the trustee will treat any portion that is not drawn upon (less the value of any substitute customer property delivered by the customer) as having been distributed to the customer for purposes of calculating entitlements to distribution or transfer.¹⁴

Residual interest and other FCM assets. The CFTC confirms that a trustee may apply a debtor FCM's residual interest on deposit in a customer account in the event of a shortfall in the customer account. More broadly, customer property includes any cash, securities, or other property in the debtor's estate, but only to the extent that the customer property under the other definitional elements is insufficient to satisfy in full all claims of the FCM's public customers.¹⁵ This includes "customer property," as defined in section 16(4) of SIPA that remains after allocation in accordance with section 8(c)(1)(A)-(D) of SIPA and that is allocated to the debtor's general estate in accordance with section 8(c)(1) of SIPA.¹⁶

In proposing these latter provisions, the CFTC took note the decision of the Bankruptcy Court for the Northern District of Illinois in *In Re Griffin Trading Company*, in which the Court ruled that the Commission exceeded its statutory authority by adopting current Rule 190.08(a)(1)(ii)(J), which similarly provides that customer property includes "cash, securities or other property of the debtor's estate" and held that it was invalid.¹⁷ Notwithstanding the Court's decision, which was subsequently vacated on appeal pursuant to a settlement reached by the parties, the CFTC reaffirmed its view that section 20 of the CEA provides it with the authority to include proposed Rule 190.09(a)(1)(ii)(L) in part 190.

Margin calls to undermargined public customer accounts. Additionally, the Proposal updates an existing rule regarding margin calls made by a trustee to undermargined accounts of public customers. As proposed, a trustee shall "as soon as practicable" liquidate all open commodity contracts in any account that is in deficit, where any mark-to-market calculation would result in a deficit; or where a customer fails to meet a margin call made by the trustee "within a reasonable time." Borrowing from guidance in relevant court decisions,¹⁸ the Proposal defines a reasonable time "absent exigent circumstances... shall be one hour or such greater period not to exceed one business day, as determined by the trustee." However, the Proposal makes clear that less one hour would be reasonable if such exigent circumstances apply in the trustee's discretion.¹⁹

Subpart C, Derivatives Clearing Organization as Debtor

DCO default management rules. As noted earlier, the Proposal provides that the trustee should follow, to the extent practicable and appropriate, the DCO's pre-existing default management rules and procedures and recovery and wind-down plans that have been submitted to the CFTC. These rules, procedures, and plans will, in most cases, have been developed pursuant to CFTC Rules 39.16 and 39.39, respectively, subject to CFTC staff oversight. This approach relieves the trustee of the burden of developing, in the moment, models to address an extraordinarily complex situation.

Conclusion

The comment period for the Proposal expires on July 13, 2020.

The Proposal is available [here](#).

¹⁴ Proposed Rule 190.04(d)(3).

¹⁵ Proposed Rule 190.09(a)(1)(ii)(L).

¹⁶ *Id.*

¹⁷ *In re Griffin Trading Co.*, 245 B.R. 291 (Bankr. N.D. Ill. 2000), vacated as mooted sub. nom., *Inskeep v. MeesPierson N.V.* (*In re Griffin Trading Co.*), 270 B.R. 882 (N.D. Ill. 2001).

¹⁸ See, e.g., *Morgan Stanley & Co. Inc. v. Peak Ridge Master SPC Ltd.*, 930 F. Supp2d 532, 539-540 (S.D.N.Y. 2013).

¹⁹ Proposed Rule 190.04(b)(4).

Changes in Part 190 Chart

Section	Subject	Proposed Change	Key Changes From Current
190.00	Statutory Authority, Organization, Core Concepts, Scope, and Construction	Proposed 190.00 set outs the statutory authority, organization, core concepts, scope, and rules of construction for part 190. Proposed 190.00 serves as a reference guide for the CFTC's intent in bankruptcies, clarifying past issues where the CFTC believes its intent has been misconstrued. Proposed 190.00 provides notable examples of the requirement of pro rata distribution in response to situations where customers have posted letters of credit to avoid pro rata treatment in a shortfall and clarifying that equitable trusts will not be an available remedy.	New addition
190.01	Account Class	Expands definitions of account classes.	Expanded definition
190.01	Physical Delivery	Expands definition to recognize that intangible commodities that may be physically delivered.	Expanded definition
190.02(a)(1)	Request for Exemption	Expanded to include any procedural provision rather than limiting to exemption from or extension to a time limit.	May request exemption from any procedure not only time limits
190.02(f)	Voluntary Petition for Bankruptcy by Receiver	New power that would explicitly permit a receiver to file a voluntary petition for bankruptcy for an FCM in appropriate cases.	New authority to file voluntary petition
190.03(a)(1)	Providing Notices	Authorizes notices by electronic mail; no longer required to submit by overnight hard copy.	Removes hard copy requirements
190.03(a)(2)	General Approach to Notices	Replaces specific procedures with any "reasonably designed" for giving notice.	Change from specific to general approach
190.03(b)	Notices to CFTC and DSROs	(1) In voluntary bankruptcy, revises time to "as soon as practicable, and in any event no later than the time of filing"; (2) in involuntary filings, must notify immediately; (3) must provide docket number "as soon as known"; (4) must notify the CFTC of intent to transfer open commodity contracts as soon as possible.	Removes three-day deadline for intent to transfer
190.03(c)	Notices to Customers	Changes notice standard to "all reasonable efforts". Trustee may then liquidate on the seventh day after the order for relief if the customer has not instructed the trustee in writing before the deadline specified in the notice to return property.	Removes requirement to publish in newspaper, removes the sixth calendar day following second publication requirement
190.03(c)(2)	Open Commodity Contracts in Hedging Accounts	(1) Trustee given authority as an option but not an obligation to treat open commodity contracts of public customers held in hedging accounts designated as such in the debtor's records as specifically identifiable property after consulting with the CFTC and when practical under the circumstances; (2) if trustee exercises this option then trustee must notify each relevant customer and request instructions whether to transfer or liquidate the relevant open commodity contracts; (3) trustee must inform customer that if instructions are not given the contracts will not be treated as specifically identifiable property.	Changes from bespoke basis to categorical basis

Section	Subject	Proposed Change	Key Changes From Current
190.03(e) & (f)	Proof of Customer Claim	Allows for trustee discretion to adapt a request for certain information to the facts of a particular case. CFTC has included a revised template form, but notes that it is within trustee's discretion whether to use form.	Deletes question on if claimant is an "affiliate" "insider" or "relative"
190.04(a)	Transfer of Open Contracts	(1) Changes "must immediately" standard to "shall promptly"; (2) retains provision that if a commodity broker demonstrates to the CFTC in a specified period of time that it is in compliance with segregation and financial requirements on the filing date, the CFTC may determine to allow the commodity broker to continue in business.	Increase in discretion
190.04(b)	Margin Payments	(1) Expansion of payment of margin payments from only "pending liquidation" to "pending transfer or liquidation"; (2) may not make payments on behalf of any commodity contract account that is in deficit; (3) FCMs or clearing organizations may exercise contractual rights based on upstream collateral, but not if an upstream margin payment would exceed the funded balance of the account; (4) trustee may but is no longer required to make margin calls for public customers; (5) a trustee must liquidate as soon as practicable all open commodity contract accounts in any commodity account (i) that is in deficit; (ii) for which mark-to-market calculation would result in a deficit; (iii) for which the customer fails to meet a margin call made by the trustee in a reasonable time (an hour or such greater period not to exceed one business day at trustee discretion).	May make margin payments pending transfer. Expands liquidation requirements for accounts that are in deficit.
190.04(b)(5)	Assigning Liquidating Positions in Omnibus Account	Trustee should liquidate accounts in risk-reducing manner based on the customer account as a whole.	Increase in trustee discretion
190.04(c)	Best Efforts to Avoid Delivery	Makes explicit current approach to liquidate promptly commodity contracts that are not settled in cash and are moving into the delivery period.	Clarification of CFTC policy
190.04(d)	Liquidation of Specifically Identifiable Property	(1) Applies to specifically identifiable property other than open commodity contracts or physical delivery property; (2) must liquidate if drops below 75% of fair market value or if failure to liquidate may result in a deficit balance.	Changes benchmark for liquidation from 90% FMV to 75% FMV
190.04(d)(3)	Customer Letters of Credit	Trustee may request that a customer deliver substitute customer property with respect to any letter of credit received, acquired or held to margin, guarantee, secure, purchase, or sell a commodity contract; amount may be less than face value at trustee's discretion. Any portion of the letter of credit not fully drawn upon will count as having been distributed to customer.	Expanded treatment for letters of credit
190.04(e)(1)(i) & (2)	Approval of Clearing Organization Rules	Deletes requirement for CFTC preapproval of rules regarding liquidation of open commodity contracts.	Removes pre-approval requirement

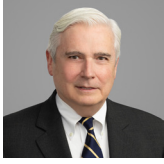
Section	Subject	Proposed Change	Key Changes From Current
190.04(e)(1)(ii)	Non-DCO or Foreign Clearing Member Debtor	Trustee “shall use commercially reasonable efforts to liquidate open commodity contracts.”	Increase in trustee discretion
190.04(e)(3)	FCM or foreign futures intermediary Upstream Rights	Confirms that upstream intermediaries may exercise contractual rights.	Clarification of CFTC policy
190.05(a) & (b)	Compliance with CEA & Funded Balance Computations	Provides flexibility to trustee by changing standard of compliance to “shall use reasonable efforts to comply” and shall use “reasonable efforts” to compute customer accounts balance until the open commodity contracts and other property in the account have been transferred or liquidated.	Shifts from mandatory to reasonable efforts standard, limits how long must compute account balances
190.05(c)(1)	Records Retention	Changes period of retention to “until such time as the debtor’s case is closed.”	Reduced requirement
190.05(d)	Account Statements	Trustee must use all reasonable efforts to continue to issue account statements.	New requirement
190.05(f)	Residual Interest Provisions	Trustee must apply residual interest provisions in a manner appropriate.	New requirement
190.06	Making and Taking Delivery under Commodity Contracts	Trustee may use reasonable efforts to permit relevant customer to make or take delivery outside the administration of the debtor’s estate.	New requirement
190.07(a)(3)	Transfers	No clearing organization or other self regulatory organization may adopt, maintain in effect, or enforce rules that prevent the acceptance by its members of transfers of open commodity contracts and the equity margining or securing of such contracts from FCMs if the CFTC has approved the transfer.	Changes from “interfere with” to prevent the creation of an active obligation.
190.07(b)(3)	Transfer of Accounts	Transferee may accept open commodity contracts and property and may open accounts on its records prior to completing customer diligence provided that account opening diligence as required is performed as soon as practicable but no later than six months after transfer unless extended by the CFTC.	Reduced requirement
190.07(d)(4)	Separation of Physical Property and Deliverable Positions	Trustee must use reasonable efforts to prevent physical delivery property from being separated from commodity contract positions under which the property is deliverable.	New requirement
190.08(b)(1)(ii) (A)(4)	Letters of Credit in Calculation of Allowed Net Equity	Face amount of any letter of credit received, acquired or held to margin, guarantee, secure, purchase or sell a commodity contract as part of the posting customer’s ledger balance.	Expanded treatment for letters of credit
190.08(d)(1)(i)	Timing for Valuation of Transferred Contract	Changes date for valuation to end of the last settlement cycle on the day proceeding the transfer.	Changes date for clarification

Section	Subject	Proposed Change	Key Changes From Current
190.08(d)(1)(ii)(A)	Weighted Average of Liquidation Prices	Trustee may use the weighted average of liquidation prices of identical commodity contracts liquidated within a 24-hour period or business day.	Expands definition of time period
190.08(d)(1)(ii)(B)	Liquation in Bulk Auctions	Valued at settlement price calculated by the clearing organization as of the end of the settlement cycle during which the commodity contract was liquidated.	Clarification of calculation
190.09	Segregation of Customer Funds and Distribution of Customer Property	Trustees must fulfill FCM obligation to put certain funds into segregation on behalf of customers where FCMs have not using the current assets of the debtor. Following SIPA, the CFTC states that any securities customer property that remains after satisfaction in full of securities claims provided for in that section of SIPA proceedings become property of the general estate and become customer property in the FCM bankruptcy proceeding. The CFTC rules allow customers to buy back identifiable property to enable pro rata distribution the proposed rule clarifies what will constitute "customer property."	Additional trustee ability
190.10(d)	Acceptance of Letters of Credit	(1) For a FCM to accept a letter of credit at any point, the letter of credit must be available for the trustee to draw upon, in full or in part, in the event of a bankruptcy proceeding, the entry of a protective decree under SIPA or the appointment of FDIC as a receiver; (2) if the letter of credit is permitted to be and is passed through a clearing organization, the bankruptcy trustee for such clearing organization or FDIC must be able to draw upon the letter of credit in the above situations.	Applies only to new letters of credits, with requirement to transition of one year from effective date.
190.10(a)	FCM Current Accounts Records	Must maintain records of customer accounts and store in a way that can be provided to another FCM in connection with the transfer of open customer contracts of other customer property.	New requirement
190.10(b)	Designation of Hedging Accounts	FCMs are required to provide customers an opportunity to designate an account as a hedging account when the customer first opens the account. Clients can make representation to FCM to have current account designated as a hedging account.	New requirement
190.10(c)	Designation of Delivery Accounts	When an FCM facilitates delivery under a customer's physical delivery contract, and such delivery is effected outside of a futures account, foreign futures account, or cleared swaps account, it must be effected through (and the associated property held in) a delivery account.	New requirement
190.11	Bankruptcy of Clearing Organization	Establishes bespoke rules that apply to clearing organizations.	New regime
190.12(a)(2)	Notice of Clearing Organization Bankruptcy	Must notify in advance of or in time of filing a petition voluntarily, or within three hours if involuntarily. Clearing organization must be prepared to give trustee copies of each of the most recent reports filed with the CFTC under 39.19(c)(1),(2),(3) and 39.39(b) within 3 hours or as soon as practicable.	New requirement

Section	Subject	Proposed Change	Key Changes From Current
190.13	DCO Transfers	DCO transfers require explicit CFTC approval.	New requirement
190.14(b)(2)	Continued Operation	Trustee may request permission from CFTC for continued operation of DCO if both useful and practicable if continued operation would facilitate within no more than six business days transfer of clearing operations to another DCO or resolution of the DCO under Title II of Dodd-Frank.	New requirement
190.14(c)(1)	Liquidation of All Open Commodity Contracts	Must be liquidated within seven days of relief unless the CFTC determines otherwise.	New requirement
190.15	DCO Rules for Insolvency	Trustee may implement DCOs must rules and procedures regarding insolvency and default adopted under 39.16 and 39.35.	New requirement
190.17(b)(2)	Allocation of Members Recovery	DCOs must adjust members' net equity claims in reverse order of the allocation of losses.	New requirement
190.18	Scope of Customer Property for DCOs	Follows approach of 190.09 FCM property. DCOs include as customer property any guarantee fund deposit, assessment or similar payment or deposits made by a member, to the extent any remains following the administration of the debtor's default rules and procedures.	New requirement
190.19	Use of Daily Settlement	Resources that are intended to flow through to members as part of daily settlement (including both daily variation payments and default resources) should be devoted to that purpose, rather than to the general estate.	New requirement

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