

## **The CFTC Adopts Comprehensive Amendments to Its Bankruptcy Rules**

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The Commodity Futures Trading Commission (CFTC) recently adopted final amendments to Part 190 of the CFTC's regulations (the "Final Rules"), governing bankruptcy proceedings with respect to commodity brokers.<sup>1</sup> The Final Rules represent the first comprehensive update to the CFTC's bankruptcy rules since the Part 190 rules were initially adopted in 1983. Approved unanimously, the Final Rules serve to modernize and revise the CFTC's regulations to reflect changes in the commodity brokerage industry over that time.

Subchapter IV, chapter 7 of the Bankruptcy Code ("Code") sets out the essential provisions governing the liquidation of a commodity broker in bankruptcy. However, the CFTC is authorized under section 20 of the Commodity Exchange Act (CEA), "notwithstanding the Code," to adopt rules that provide, among other things: (1) that 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. Part 190 of the CFTC's regulations are promulgated under this authority as well as the CFTC's general rulemaking authority under section 8a(5) of the CEA.

Since the initial adoption of the Part 190 rules, there have been significant developments in practices with respect to commodity broker bankruptcies, including as a result of judicial decisions and certain high-profile bankruptcies (like that of MF Global Inc. and Peregrine Financial Group Inc.). As emphasized in former Chairman Heath Tarbert's statement in support of the Final Rules, they seek to clarify and codify key principles and approaches or practices that have developed over time as the

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existing Part 190 rules were applied to real-world bankruptcy situations.

## Highlights of the Final Rules

At a high level, the Final Rules address the following major topics:

**Statutory Authority, Organization, Core Concepts, Scope and Construction.** The Final Rules adopt new CFTC Rule 190.00, which sets forth the statutory authority, organization, core concepts, scope and rules of construction for Part 190 of the CFTC's regulations. In particular, new CFTC Rule 190.00 sets out the CFTC's intent regarding bankruptcies for the benefit of market participants, trustees and the general public.

**Default of a Derivatives Clearing Organization.** The Final Rules adopt new Subpart C to Part 190 of the CFTC's regulations, which governs the bankruptcy of a DCO. Among other things, new Subpart C 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 Part 39 of the CFTC's regulations, 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.

**Priority of Customers and Customer Property.** The Final Rules clarify that shortfalls in segregated property should be made up from the general assets of the FCM. The Final Rules also clarify that, with respect to customer property, public customers are favored over non-public customers.

**Securities Investors Protection Act (SIPA) and Federal Deposit Insurance Corporation (FDIC).** The Final Rules confirm the applicability of Part 190 of the CFTC's regulations in the context of an FCM that also is registered with the Securities and Exchange Commission (SEC) as a broker-dealer and subject to a proceeding guided primarily by the SIPA. Likewise, the Final Rules clarify the applicability of Part 190 in the context of a proceeding in which the FDIC is acting as receiver.

**Letters of Credit as Collateral.** The Final Rules confirm the treatment of letters of credit used as collateral. Specifically, the Final Rules make clear that customers posting letters of credit as collateral will be subject to the same pro rata loss as customers that post other types of collateral, such as cash and securities, both during business as usual and during bankruptcy. The pro-rata loss would be calculated based on the face value of the posted letter of credit, even if only a portion was drawn down by a customer at the time of the bankruptcy.

**Greater Trustee Discretion.** The Final Rules grant trustees greater discretion by, among other things, permitting the trustees to treat public customers on an aggregated basis. This greater discretion generally favors the cost effective and prompt distribution of customer property over the precision of valuing each customer's entitlements on an individual basis.

**Transferring Rather Than Liquidating Customer Positions.** The Final Rules further confirm the CFTC's longstanding preference for transferring positions of public customers rather than liquidating the positions.

**Reflect Changes to CFTC's Regulatory Framework.** The Final Rules update Part 190 of the CFTC's regulations to better reflect changes to the CFTC's regulatory framework over the years, including the CFTC's recent revisions to its customer protection rules. The Final Rules also update

cross-references to other CFTC rules.

**Changes in Technology.** The Final Rules also reflect changes in technology, including a recognition that many records are captured and stored electronically rather than on paper.

**Non-Substantive Clarifications.** The Final Rules provide non-substantive changes to clarify language in the CFTC's regulations. These clarifications are intended to address ambiguities that have complicated past bankruptcies.

A chart summarizing all of the provisions in the Final Rules is available in this advisory's appendix.

### **Effective Date of the Final Rules**

The Final Rules are effective 30 days after publication in the *Federal Register*.

### **Principal Changes From the Proposed Rules and Supplemental Proposed Rules**

The Final Rules differ from the proposed amendments<sup>2</sup> and supplemental amendments,<sup>3</sup> published in the *Federal Register* on June 12, 2020 and September 24, 2020, respectively, in a few key respects. In particular, the Final Rules clarify in CFTC Rule 190.11 that if a debtor clearing organization is organized outside the United States, then only selected provisions in Part 190 of the CFTC's regulations would apply, including (1) the general provisions in Subpart A to Part 190; (2) the reports and records requirements in CFTC Rule 190.12; and (3) the prohibition on avoidance of transfers in Rule 190.13 and the net equity calculation and treatment of property requirements in Rules 190.17 and 190.18, but only with respect to an FCM clearing member's public customers. The CFTC expressed its rationale in adopting the final scheme as a balance between protecting customers and mitigating conflict with foreign proceedings.

Additionally, the CFTC adopted a simplified CFTC Rule 190.14(b) that is consistent with DCO rules governing the default of the DCO. As originally proposed, Rule 190.14(b) included additional provisions that were intended to provide a brief opportunity, after the order for relief, to enable alternatives (i.e., resolution under Title II of the Dodd–Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") or the transfer of clearing operations to another DCO) in lieu of liquidation. In response to comments following the Proposed Rules, the CFTC withdrew proposed paragraphs (b)(2) and (b)(3) and issued the Supplemental Proposed Rules with an alternative approach to facilitate the potential resolution of a systemically important DCO under Title II of the Dodd-Frank Act. In adopting the Final Rules, the CFTC determined not to go forward with the Supplemental Proposed Rules. As adopted, Rule 190.14(b) provides only that subsequent to the order for relief, the DCO must cease making calls for variation settlement or initial margin. Relatedly, former Chairman Heath Tarbert noted that the CFTC will engage in "further analysis and development before proposing this, or any other, alternative approach."

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