

CFTC Proposes to Streamline Uncleared Swap Segregation Rules

August 6, 2018

On July 24, 2018, the Commodity Futures Trading Commission (the “CFTC”) unanimously approved a Notice of Proposed Rulemaking (the “**Proposal**”)¹ to amend its regulations governing the right of counterparties to elect segregation of initial margin posted to swap dealers (“**SDs**”) and major swap participants (“**MSPs**”) in connection with uncleared swap transactions (the “**IM Seg Rules**”).²

The Proposal responds to concerns regarding the high degree of complexity in administering the IM Seg Rules, which goes beyond what is required by the Commodity Exchange Act (“**CEA**”) and places significant burdens on SDs, MSPs and their counterparties, despite the fact that a very small minority of counterparties have elected to segregate margin pursuant to the IM Seg Rules.³ Accordingly, the Proposal is designed to align the requirements of the IM Seg Rules more closely with the statutory text.

This Memorandum provides an overview of the Proposal. Included as Appendix A to this Memorandum is a comparison showing changes that would be implemented by the Proposal to the text of the current IM Seg Rules. Comments on the Proposal are due by September 28, 2018.

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¹ Segregation of Assets Held as Collateral in Uncleared Swap Transactions, 83 Fed. Reg. 36484 (July 30, 2018).

² CFTC Regulations, Subpart L; 17 C.F.R. §§ 23.700-704; Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy, 78 Fed. Reg. 66621 (Nov. 6, 2013).

³ In his concurring statement on the Proposal, however, CFTC Commissioner Rostin Benham suggested that perhaps imposing more rigid segregation requirements on SDs and MSPs would increase incentives for counterparties to elect segregation.



Background

- In 2010, the Dodd-Frank Act amended the CEA to add Section 4s(l), which provides a counterparty with the right to elect segregation of initial margin posted to an SD or MSP for uncleared swap transactions.⁴ Section 4s(l) also includes related notification and reporting requirements.⁵
- In 2013, the CFTC implemented these requirements when it finalized the IM Seg Rules. As noted below, the IM Seg Rules went well beyond the CEA to impose additional conditions on required segregation notices and account requirements. The IM Seg Rules became effective on May 5, 2014 for new counterparties and November 3, 2014 for existing counterparties.
- In October 2014, the CFTC issued an interpretive letter (“**Letter 14-132**”),⁶ which provided guidance reducing some of the complexity and ambiguity associated with the IM Seg Rules, but still retained most of the IM Seg Rules’ extra-statutory requirements.
- The CFTC and Prudential Regulators⁷ subsequently finalized uncleared swaps margin rules (“**Mandatory Margin Rules**”),⁸ which require a minimum amount of initial margin to be exchanged with, and segregated by, certain counterparties.⁹ As part of the

Mandatory Margin Rules, the CFTC clarified that the IM Seg Rules do not apply to initial margin covered by its version of the Mandatory Margin Rules, but it did not address the Prudential Regulators’ parallel rules.

- In 2017, the CFTC initiated Project KISS, pursuant to which it requested and received public comment on streamlining the CFTC’s regulations,¹⁰ including comments suggesting that the CFTC simplify some of the more burdensome and prescriptive aspects of the IM Seg Rules.

The CFTC Proposal*Notification Requirements*

- The Proposal would amend the notice provisions of the IM Seg Rules by eliminating extra-statutory requirements to:
 - provide annual re-notification of the right to elect segregation;
 - include specified information regarding eligible third-party custodians and the costs of segregation;
 - provide notification to a specified officer of the counterparty;¹¹ and

⁴ CEA § 4s(l); 7 U.S.C. § 6s(l).

⁵ Id.

⁶ CFTC Letter No. 14-132 (Oct. 31, 2014).

⁷ The Prudential Regulators include the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency.

⁸ Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 636 (Jan. 6, 2016); Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. (Nov. 30, 2015).

⁹ See CGSH Alert Memorandum, “Agencies Finalize Margin Rules for Non-Cleared Swaps and Security-Based Swaps” (Jan. 28, 2016), available at <https://www.clearygottlieb.com/-/media/organize-archive/cgsh/files/publication-pdfs/agencies-finalize-margin-rules-for-non-cleared-swaps-and-security-based-swaps.pdf>

¹⁰ See Project KISS, 82 Fed. Reg. 23765 (May 24, 2017); Project KISS, 82 FR 21494 (May 6, 2017).

¹¹ The CFTC indicated in the Proposal that it expects SDs and MSPs to use reasonable judgment to identify an

- obtain confirmation from the counterparty of both its receipt of the notification and its decision whether to elect segregation.
- Under the Proposal, the obligations of the SD or MSP with respect to counterparty notification would thus be limited to:
 - providing a single notification of the counterparty's right to elect segregation of initial margin at the beginning of the first swap transaction that provides for the exchange of initial margin;¹² and
 - for counterparties electing segregation, obtaining written confirmation of such election and establishing the terms of such segregation by written agreement.
- As under the current IM Seg Rules, the Proposal would permit a counterparty to change its election whether or not to segregate at its discretion by written notice to the SD or MSP.
- The Proposal's amendments would supersede interpretive relief in Letter 14-132 that had permitted reliance on negative consent not to segregate because, as amended, the IM Seg Rules would no longer require an SD or MSP to obtain confirmation of an election not to segregate.
- Like Letter 14-132, the Proposal would clarify that the IM Seg Rules only apply to counterparties that post initial margin. In addition, the Proposal would clarify that the right to segregation under the IM Seg Rules, and the associated notification requirement,

appropriate person at the counterparty who can evaluate the right to elect segregation.

¹² The CFTC noted in the Proposal that segregation notices sent under the current IM Seg Rules would be

would not apply to margin segregated pursuant to the Prudential Regulators' Mandatory Margin Rules, in addition to the CFTC's Mandatory Margin Rules.

Requirements for Custody of Segregated Initial Margin

- The Proposal would retain the requirements that (1) a custodian of initial margin be a legal entity independent of both the SD or MSP and the counterparty (although such entity may be affiliated with the SD, MSP or counterparty) and (2) the initial margin be held in an account "segregated for, and on behalf of, the counterparty, and designated as such."
 - This account naming requirement continues to raise questions regarding customary segregation arrangements for initial margin, in which the custodial account is typically held in the name of the pledgor for the benefit of the secured party.
- The Proposal would also retain the requirement that the parties enter into a written segregation agreement that requires, at a minimum, written instruction and notification of any withdrawals of initial margin.
- However, the Proposal would eliminate the requirement for withdrawals of margin to be accompanied by a statement to the custodian that is, sworn, written, subject to penalty of perjury, and states that the relevant party is entitled to assume control of the initial margin.

Investment of Segregated Initial Margin

- The Proposal would continue to permit parties to enter into contractual arrangements requiring the investment of segregated margin

sufficient for purposes of complying with the IM Seg Rules as amended by the Proposal. Proposal at 36487 n.25.

and related allocation of investment gains and losses.

- However, the Proposal would remove the requirement that segregated initial margin be invested in a manner consistent with CFTC Regulation 1.25.
 - CFTC Regulation 1.25 is intended to protect clients trading in exchange-traded futures and cleared swaps, which are subject to standardized terms, including with respect to the investment of segregated initial margin; in contrast, in the context of uncleared swaps, parties regularly negotiate bespoke transactions and are able to negotiate contractual protections and to agree on investment decisions for segregated initial margin in that context.¹³
 - Additionally, because investment decisions for segregated margin for uncleared swaps are typically made by the counterparty and/or custodian – not the SD or MSP – applying CFTC Regulation 1.25 in this context would be detrimental to the counterparty’s interests by restricting its investment discretion. Nor are such restrictions necessary to protect the SD or MSP since, by definition, the IM Seg Rules apply to margin the SD or MSP is not required to collect in the first place.
- The Proposal would, however, streamline implementation of this requirement by:
 - eliminating the obligation of the chief compliance officer (“CCO”) of the SD or MSP to be the individual who provides the quarterly report, since the CCO might not be the best-placed individual to do so;¹⁴
 - clarifying the timing of delivery of the report (no later than 15 business days after the end of the relevant quarter); and
 - eliminating the requirement that the report indicate whether or not the back office procedures were not in compliance with the agreement of the parties “at any point during the previous calendar quarter.”
 - Although the CFTC did not provide guidance as to the content of the quarterly reporting obligation, SDs and MSPs have established practices in this area that we would expect to continue following adoption of the Proposal.

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Reporting Requirements for Non-Segregated Initial Margin

- The Proposal would retain rules addressing the statutory requirement for SDs and MSPs to report quarterly to counterparties not electing segregation of initial margin whether the back office procedures of the SD or MSP relating to margin and collateral requirements are in compliance with the agreement of the parties.

¹³ The Proposal does acknowledge that, in some situations, nonfinancial end-user counterparties may have less negotiating power with SDs or MSPs as a result of this Proposal, and the Proposal solicits comments on these issues, including whether counterparties are at a disadvantage in negotiating the terms for segregation arrangements more generally. Proposal at 36491.

¹⁴ The Proposal does note, however, that the CCO would remain responsible, under CFTC Regulation 3.3, for addressing non-compliance issues, including issues related to these procedures.

APPENDIX A

Subpart L— Segregation of Assets Held as Collateral in Uncleared Swap**Transactions****§ 23.700 Definitions.**

As used in this subpart:

Initial Margin means money, securities, or property posted by a party to a swap as performance bond to cover potential future exposures arising from changes in the market value of the position.

~~Margin means both Initial Margin and Variation Margin.~~

~~Segregate.~~ To segregate means to keep two or more items ~~is to keep them~~ in separate accounts, and to avoid combining them in the same transfer between two accounts.

Variation Margin means a payment made by or collateral posted by a party to a swap to cover the current exposure arising from changes in the market value of the position since the trade was executed or the previous time the position was marked to market.

§ 23.701 Notification of right to segregation.

(a) ~~Prior to the execution of each~~ At the beginning of the first swap transaction that ~~is not submitted for clearing~~ provides for the exchange of Initial Margin, a swap dealer or major swap participant ~~shall~~ must notify the counterparty that

~~(1) Notify each counterparty to such transaction that~~ the counterparty has the right to require that any Initial Margin the counterparty provides in connection with such transaction be segregated in accordance with §§ 23.702 and 23.703, except in those circumstances where segregation is mandatory pursuant to §23.157; or rules adopted by the prudential regulators pursuant to section 4s(e)(2)(A) of the Act.

~~(2) Identify one or more custodians, one of which must be a creditworthy non-affiliate and each of which must be a legal entity independent of both the swap dealer or major swap participant and the counterparty, as an acceptable depository for segregated Initial Margin; and~~

~~(3) Provide information regarding the price of segregation for each custodian identified in paragraph (a)(2) of this section, to the extent that the swap dealer or major swap participant has such information.~~

(b) The right referred to in paragraph (a) of this section does not extend to Variation Margin.

(c) If the counterparty elects to segregate Initial Margin, the terms of segregation shall be established by written agreement. ~~The notification referred to in paragraph (a) of this section shall be made to an officer of the counterparty responsible for the management of collateral. If no such party is identified by the counterparty to the swap dealer or major swap participant, then the notification shall be made to the Chief Risk Officer of the counterparty, or, if there is no such Officer, the Chief Executive Officer, or if none, the highest level decision-maker for the counterparty.~~

~~(d) Prior to confirming the terms of any such swap, the swap dealer or major swap participant shall obtain from the counterparty confirmation of receipt by the person specified in paragraph (c) of this section of the notification specified in paragraph (a) of this section, and an election, if applicable, to require such segregation or not. The swap dealer or major swap participant shall maintain such confirmation and such election as business records pursuant to §1.31 of this chapter.~~

~~(e) Notification pursuant to paragraph (a) of this section to a particular counterparty by a particular swap dealer or major swap participant need only be made once in any calendar year.~~

(fd) A counterparty's election, if applicable, to require segregation of Initial Margin or not to require such segregation, may be changed at the discretion of the counterparty upon written notice delivered to the swap dealer or major swap participant, which changed election shall be applicable to all swaps entered into between the parties after such delivery.

§ 23.702 Requirements for segregated initial margin.

(a) The custodian of Initial Margin, segregated pursuant to an election under § 23.701, must be a legal entity independent of both the swap dealer or major swap participant and the counterparty.

(b) Initial Margin that is segregated pursuant to an election under § 23.701 must be held in an account segregated for, and on behalf of, the counterparty, and designated as such. Such an account may, if the swap dealer or major swap participant and the counterparty agree, also hold Variation Margin.

(c) Any agreement for the segregation of Initial Margin pursuant to this section shall be in writing, shall include the custodian as a party, and shall provide that: any instruction to withdraw Initial Margin shall be in writing and that ~~(1) Any withdrawal of such Margin, other than pursuant to paragraph (c)(2) of this section, shall only be made pursuant to the agreement of both the counterparty and the swap dealer or major swap participant, and~~ notification of ~~such~~the withdrawal shall be given immediately to the non-withdrawing party;.

~~(2) Turnover of control of such Margin shall be made without the written consent of both parties, as appropriate, to the counterparty or to the swap dealer or major swap participant, promptly upon presentation to the custodian of a statement in writing, made under oath or under penalty of perjury as specified in 28 U.S.C. 1746, by an authorized representative of either such party, stating that such party is entitled to such control pursuant to an agreement between the parties. The other party shall be immediately notified of such turnover.~~

§ 23.703 Investment of segregated initial margin.

~~(a) Margin that is segregated pursuant to an election under §23.701 may only be invested consistent with §1.25 of this chapter.~~

~~(b) Subject to paragraph (a) of this section, the~~The swap dealer or major swap participant and the counterparty may enter into any commercial arrangement, in writing, regarding the investment of ~~such~~Initial Margin; segregated pursuant to § 23.701 and the related allocation of gains and losses resulting from such investment.

§ 23.704 Requirements for non-segregated margin.

(a) ~~The chief compliance officer of e~~Each swap dealer or major swap participant shall report to each counterparty that does not choose to require segregation of Initial Margin pursuant to § 23.701(a), on a quarterly basis, no later than the fifteenth business day ~~of each calendar~~after the end of the quarter, ~~on whether or not that~~ the back office procedures of the swap dealer or major swap participant relating to margin and collateral requirements ~~were, at any point during the previous calendar quarter, not~~are in compliance with the agreement of the counterparties.

(b) The obligation specified in paragraph (a) of this section shall apply ~~with respect to each counterparty~~ no earlier than the 90th calendar day after the date on which the first swap is transacted between the counterparty and the swap dealer or major swap participant.