

MEMO# 31705

April 9, 2019

CFTC Adopts Amendments to Notification Requirements for Segregation of Margin for Uncleared Swap Transactions

[31705]

April 9, 2019 TO: ICI Members

Investment Company Directors

Derivatives Markets Advisory Committee SUBJECTS: Compliance

Derivatives

Disclosure

Investment Advisers

Operations

Trading and Markets RE: CFTC Adopts Amendments to Notification Requirements for Segregation of Margin for Uncleared Swap Transactions

The Commodity Futures Trading Commission (CFTC) recently adopted amendments that simplify how swap dealers (SDs) and major swap participants (MSPs) notify counterparties of their right to segregate initial margin for uncleared swaps and modify requirements for the handling of segregated initial margin.[\[1\]](#) The CFTC adopted the amendments without change from its proposal last summer.[\[2\]](#) The amendments will become effective on May 3, 2019.

Background

The amendments apply to subpart L of the CFTC's regulations,[\[3\]](#) which implements the requirements for segregation of initial margin for uncleared swap transactions in Section 4s(l) of the Commodity Exchange Act. These requirements apply only to the segregation of initial margin in circumstances where segregation is *not mandatory*. The CFTC's 2015 margin rule for uncleared swaps ("CFTC Margin Rule") mandates bilateral exchange of initial and variation margin for CFTC-regulated SDs and MSPs and their counterparties.[\[4\]](#) The CFTC Margin Rule also requires third-party segregation of initial margin that is required to be posted pursuant to the rule. Thus, Regulations 23.702 and 23.703 generally apply only when initial margin is to be exchanged between an SD or MSP and (i) a nonfinancial end-user, or (ii) a financial end-user without "material swaps exposure," as defined in the CFTC Margin Rule.[\[5\]](#)

Amendments

The CFTC issued the amendments as part of its Project KISS initiative.^[6] The CFTC was concerned that the detailed requirements of the subpart L regulations have been difficult for SDs and MSPs to implement and satisfy, and that very few swap counterparties have exercised their right to elect to segregate initial margin pursuant to these rules. Key elements of the CFTC's amendments include:

Notification of the Right to Require Segregation

Regulation 23.701 directs an SD or MSP to notify each counterparty of the right to require segregation of initial margin. The amendments revise the rule to require that the notification of a counterparty be made prior to execution of the first uncleared swap transaction that provides for the exchange of initial margin, rather than prior to each transaction or annually as the rule currently requires. The CFTC also eliminated the notification requirement when segregation is mandatory, eliminated the requirement to identify one or more creditworthy, independent custodians, and eliminated the requirement to provide information in the notice regarding the price of segregation. The CFTC added a new provision specifying that if a counterparty elects to segregate initial margin, the terms of segregation shall be established by written agreement.

The CFTC eliminated existing requirements in the rule regarding confirmation of a counterparty's receipt of notification, which are more extensive than the notification requirements in Section 4s(l). The CFTC noted that the rule's existing requirement that an SD or MSP not execute a swap with a counterparty until it receives confirmation of the counterparty's receipt of the notification could block swap trading in some instances.

Custody Requirements for Initial Margin

Regulation 23.702 sets out third-party custody requirements for initial margin segregated pursuant to a counterparty's election under Regulation 23.701. Among other things, the rule provides specific requirements for withdrawal and turnover of control of initial margin. The CFTC was concerned that these requirements were overly prescriptive and should be made more flexible to accommodate the variety of arrangements that may exist between parties, which may require different notice procedures and agreements. The CFTC therefore amended the rule to leave these matters up to negotiation by the parties.

Investment of Segregated Margin

Regulation 23.703 requires initial margin segregated pursuant to subpart L to be invested in a manner consistent with CFTC Regulation 1.25, which limits how a futures commission merchant or derivatives clearing organization may invest customer funds. The CFTC eliminated the reference to Regulation 1.25 in Regulation 23.703 and amended the rule to provide SDs or MSPs and their counterparties with flexibility to negotiate how segregated margin may be invested.

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endnotes

^[1] *Segregation of Assets Held as Collateral in Uncleared Swap Transactions*, 84 Fed. Reg.

12894 (Apr. 3, 2019), *available at* <https://www.cftc.gov/sites/default/files/2019-04/2019-06424a.pdf>.

[2] See ICI Memorandum No. 31323 (Aug. 9, 2018), *available at* https://www.ici.org/my_ici/memorandum/memo31323.

[3] Subpart L consists of CFTC Regulations 23.700 through 23.704.

[4] For a description of the CFTC Margin Rule, please see ICI Memorandum No. 29587 (Dec. 22, 2015), *available at* https://www.ici.org/my_ici/memorandum/memo29587. The Margin Rule requires an SD or MSP to exchange initial margin with a counterparty that is a financial end user that has “material swaps exposure” and to exchange variation margin with a counterparty that is an SD, MSP, or a financial end user, regardless of threshold. An entity has “material swaps exposure” if the entity and its affiliates have an average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, FX forwards and FX swaps with all counterparties for June, July, and August of the previous year that exceeds \$8 billion.

[5] Registered investment companies are generally subject to third-party custody requirements with respect to both their initial and variation margin. See Section 17(f) of the Investment Company Act of 1940 and the rules thereunder.

[6] See *Project KISS*, 82 Fed. Reg. 21494 (May 9, 2017).