

MEMO# 27690

November 8, 2013

CFTC Adopts Final Rules on Protection of Collateral of Counterparties to Uncleared Swaps

[27690]

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TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 90-13
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 77-13
INVESTMENT ADVISER MEMBERS No. 71-13
SEC RULES MEMBERS No. 101-13 RE: CFTC ADOPTS FINAL RULES ON PROTECTION OF COLLATERAL OF COUNTERPARTIES TO UNCLEARED SWAPS

The Commodity Futures Trading Commission (“CFTC” or “Commission”) has adopted final rules with respect to the treatment of collateral posted by counterparties of swap dealers (“SDs”) and major swap participants (“MSPs”) to margin, guarantee, or secure uncleared swaps (“Final Rules”). [\[1\]](#) In addition, the Final Rules include revisions to ensure that, for purposes of subchapter IV of chapter 7 of the Bankruptcy Code, securities held in a portfolio margining account that is a futures account or a cleared swaps customer account constitute “customer property” and owners of such account constitute “customers.”

Margin Segregation for SD or MSP Counterparties for Uncleared Swaps

Section 724(c) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) added section 4s(l) to the Commodity Exchange Act (“CEA”) setting forth certain requirements regarding the rights of counterparties of SDs and MSPs to elect segregation of money, securities, or other property used to margin, guarantee, or otherwise secure uncleared swaps. The Final Rules implementing the statutory requirements are set forth in section 4s(l) of the CEA.

Compliance with the Final Rules is required no later than May 5, 2014 for uncleared swap transactions that are entered into with “new counterparties.” [\[2\]](#) Compliance is required no later than November 3, 2014 for uncleared swap transactions that are entered into with “existing counterparties.” [\[3\]](#)

Notification of Right to Segregation

Required Notification

Under the Final Rules, an SD or MSP is required to notify each of its counterparties of the right to require any initial margin posted by it to be segregated in accordance with CFTC regulations. [\[4\]](#) The SD and MSP must provide certain disclosure to their counterparties including the price associated with segregation, including custodial fees, to the extent that the SD or MSP has such information. The SD and MSP also must provide the identity of one or more acceptable custodians. The notifications by SDs and MSPs must include at least one credit-worthy non-affiliate as an option for a custodian of segregated initial margin.

The Final Rules require notification to be made to an appropriate decision-maker with the counterparty organization. The notification must be sent to the officer in the counterparty responsible for the management of collateral. If such a person is not identified by the counterparty to the SD or MSP, the notification should be sent to the Chief Risk Officer, or if there is no such Officer, the Chief Executive Officer, or if none, the highest level decision-maker for the SD's or MSP's counterparty.

Under the Final Rules, an SD or MSP satisfies the notification requirement when it provides notification to a counterparty, at least once, in each calendar year.

Required Confirmation

The Final Rules require that the SD or MSP obtain from the counterparty confirmation of receipt of the segregation notification by a specified decision-maker and whether the counterparty has elected to exercise its section 4s(l) segregation rights. The CFTC believes the confirmation of receipt of the segregation notification and the counterparty's decision whether to elect segregation should be obtained prior to confirming the terms of the uncleared swap.

Power to Change Election with Regard to Segregation

Under the Final Rules, a counterparty's election with respect to the segregation of initial margin may be changed at the discretion of the counterparty upon delivery of written notice and such decision shall be applicable with respect to swaps entered into between the parties after such delivery.

Requirements for Segregated Margin

Independent Custodian and Separate Account

The Final Rules require initial margin for which segregation has been elected to be held in an account designated as a segregated account for and on behalf of the counterparty. Although segregation does not apply to variation margin, an SD or MSP and its counterparty may agree that variation margin also may be held in such segregated account. According to the CFTC, the statute does not require that affiliates of a counterparty be prohibited from serving as the custodian for segregated funds. In light of the correlated insolvency risk of affiliates if an SD or MSP were to become insolvent, the CFTC has decided that an SD or MSP should be required to provide the counterparty with at least one credit worthy non-affiliate as an option to serve as the custodian.

Requirements for Custody Agreement

The CFTC has imposed certain requirements on agreements for the segregation of margin. An agreement for the segregation of margin will be required to be in writing and to include the custodian as a party. The agreement also must provide that turnover of control shall be made promptly upon presentation of a statement in writing, signed by an authorized person under penalty of perjury that one party is entitled to such turnover pursuant to an agreement between the parties.

Investment of Segregated Margin

In the Final Rules, segregated initial margin may only be invested consistent with the standards for investment of customer funds in Rule 1.25. The CFTC noted that the Final Rules only restrict the manner in which an SD or MSP may invest margin that is segregated pursuant to an election. The Final Rules do not restrict the types of collateral that a counterparty may post to an SD or MSP nor do they require an SD or MSP to convert posted collateral.

In addition, the Final Rules provide that an SD or MSP and the counterparty may enter into any written commercial arrangement regarding the terms of the investment of segregated margin and the related allocation of gains and losses resulting from such investment.

Requirements for Non-Segregated Margin

Finally, the Final Rules implement the statutory provision that mandates that if the counterparty does not choose to require segregation, the SD or MSP shall report to the counterparty on a quarterly basis that the back office procedures of the SD or MSP are in compliance with the agreement of the counterparties. The Final Rules make the Chief Compliance Officer of the SD or MSP responsible for such a report.

Portfolio Margining

The CFTC adopted changes to the definition of “customer” in Rule 190.01(k) and the definition of “customer property” in Rule 190.08(a)(1)(i)(F) to implement section 713 of the Dodd-Frank Act. These changes are to ensure that securities held in a portfolio margining account carried as a futures account or cleared swaps customer account are customer property and the owners of those accounts are customers for purposes of subchapter IV of chapter 7 of the U.S. Bankruptcy Code.;

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endnotes

[1] Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy, 78 FR 66621 (Nov. 6, 2013), available at <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2013-26479a.pdf>.

[2] A “new counterparty” is a counterparty with whom, at the time of the effective date of the Final Rules (January 6, 2014), no agreement exists between the SD or MSP and that counterparty concerning uncleared swaps.

[3] An “existing counterparty” is a counterparty with whom, at the time of the effective

date of the Final Rules (January 6, 2014), an agreement exists between the SD or MSP and that counterparty concerning uncleared swaps.

[4] The Final Rules incorporate the statutory limitation that the right to segregation does not apply to variation margin. The CFTC, however, notes that the Final Rules do not restrict parties from negotiating segregation arrangements for variation margin.

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