

MEMO# 31323

August 9, 2018

CFTC Proposes to Amend Notification Requirements for Segregation of Margin for Uncleared Swap Transactions

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August 9, 2018 TO: Derivatives Markets Advisory Committee RE: CFTC Proposes to Amend Notification Requirements for Segregation of Margin for Uncleared Swap Transactions

The Commodity Futures Trading Commission recently issued a proposal to simplify how swap dealers (SDs) and major swap participants (MSPs) must notify counterparties of their right to segregate initial margin for uncleared swaps, and to modify requirements for the handling of segregated initial margin (Proposal).[\[1\]](#) Comments on the Proposal are due September 28, 2018.

We will discuss on our next monthly call of ICI's Derivatives Markets Advisory Committee (DMAC) whether we should comment on the Proposal. That call will take place on August 21st, from 12-1 pm ET. As a reminder, the dial-in information for the monthly DMAC call is:

US Dial-in Number: 866-734-4854

International Dial-in Number: 1-203-763-0194

Passcode: 7850498

Background

The Proposal would amend subpart L of the CFTC's regulations,[\[2\]](#) which implements the requirements for segregation of initial margin for uncleared swap transactions in Section 4s(l) of the Commodity Exchange Act.[\[3\]](#) Importantly, 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.[\[5\]](#)

Proposal

The CFTC is issuing the Proposal as part of its Project KISS initiative.^[6] The Commission is 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.^[7] Key elements of the Proposal 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 CFTC proposes to 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 would eliminate the notification requirement when segregation is mandatory, eliminate the requirement to identify one or more creditworthy, independent custodians, and eliminate the requirement to provide information in the notice regarding the price of segregation. The CFTC would add a new provision specifying that if a counterparty elects to segregate initial margin, the terms of segregation shall be established by written agreement.

The Commission proposes to eliminate 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 notes that the rule's 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 Commission believes that these requirements should be less prescriptive to accommodate the variety of arrangements that may exist between parties, which may require different notice procedures and agreements, and therefore proposes 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 Commission Regulation 1.25, which limits how a futures commission merchant or derivatives clearing organization may invest customer funds. The Commission proposes to eliminate the reference to Regulation 1.25, and instead 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*, 83 Fed. Reg. 36484 (July 30, 2018), available at <https://www.cftc.gov/sites/default/files/2018-07/2018-16176a.pdf>.

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

[3] Section 4s(l) was added to the Commodity Exchange Act by the Dodd-Frank Wall Street Reform and Consumer Protection Act.

[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).

[7] Commissioner Behnam has voiced concerns with the Proposal, although he voted for it. See Proposal at Appendix 3 (Concurring Statement of Commissioner Rostin Behnam).