

CLIENT UPDATE

FINAL CFTC RULES ON PROTECTION OF COLLATERAL FOR UNCLEARED SWAPS AND TREATMENT OF PORTFOLIO MARGINING ACCOUNT IN BANKRUPTCY

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Section 724(c) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) amended the Commodity Exchange Act (the “CEA”) by adding section 4s(l) of the CEA, which sets forth certain requirements concerning the rights of a counterparty of a swap dealer (“SD”) or major swap participant (“MSP”) with respect to the segregation of money, securities or other property used to margin, guarantee or otherwise secure uncleared swaps. These requirements apply only to initial margin.

Section 713(c) of the Dodd-Frank Act amended the CEA by adding section 20(c) of the CEA, which requires the CFTC to exercise its authority to ensure that, in the event of a commodity broker bankruptcy, the securities held in a portfolio margining account carried as a futures account will constitute “customer property” and the owners of such an account will constitute “customers” for purposes of subchapter IV of chapter 7 of the U.S. Bankruptcy Code (the “Code”).

On October 30, 2013, the Commodity Futures Trading Commission (the “CFTC”) adopted the following rules (the “Final Rules”):

- imposing requirements on SDs and MSPs with respect to the treatment of collateral posted by their counterparties to margin, guarantee or secure uncleared swaps, set forth in Subpart L of Part 23 of the regulations of the CFTC (the “Part 23 Rules”); and

- revising Part 190 of the regulations of the CFTC to ensure that, for purposes of subchapter IV of chapter 7 of the Code, portfolio margining arrangements involving swaps receive the same bankruptcy protection as portfolio margining arrangements involving futures (the “Part 190 Rules”).

The text of the Final Rules can be found at:

<http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2013-26479a.pdf>.

EFFECTIVE DATE AND COMPLIANCE DATES

The Final Rules were published in the Federal Register on November 6, 2013, and will become effective on January 6, 2014 (the “Effective Date”).

With respect to Part 190 Rules, all parties must comply by the Effective Date.

With respect to Part 23 Rules, compliance is as follows:

- Where no agreement (*e.g.*, an ISDA Master Agreement) exists between the SD or MSP (the “SD/MSP”) and its counterparty concerning uncleared swaps on the Effective Date (*i.e.*, for transactions involving “new counterparties”), the counterparties to an uncleared swap must be in compliance with the Part 23 Rules with respect to that swap no later than May 5, 2014.
- Where an agreement does exist between the SD/MSP and its counterparty on the Effective Date (*i.e.*, for transactions involving “existing counterparties”), the counterparties to an uncleared swap must be in compliance with the Part 23 Rules with respect to that swap no later than November 3, 2014. However, the Part 23 Rules do not apply to swaps entered into prior to the Effective Date.

PART 23 RULES: MARGIN SEGREGATION FOR SD OR MSP COUNTERPARTIES TO UNCLEARED SWAPS

Statutory Background

Section 4s(l) of the CEA requires, among other things:

- that an SD/MSP notify each counterparty at the beginning of a swap transaction that the counterparty has the right to require segregation of the funds or other property supplied to margin, guarantee or secure the counterparty’s obligations (the “Notification Requirement”); and

- that, at the request of the counterparty, the SD/MSP segregate such funds or other property from the assets of the SD/MSP (the “Segregation Requirement”).

Notification of Right to Segregation

The Part 23 Rules implement the Notification Requirement by requiring SDs and MSPs to notify each counterparty to an uncleared swap of its right to require that its initial margin be segregated, where to “segregate” two or more items is defined as keeping them in separate accounts and avoiding combining them in the same transfer between two accounts.

Specifically, section 23.701 of the regulations of the CFTC (the “Regulations”) requires that, prior to the execution of a swap that is not submitted for clearing, an SD/MSP must provide the following information (the “Initial Margin Segregation Information”):

- notify each counterparty that the counterparty has the right to require that any “Initial Margin” it provides in connection with such transaction be segregated in accordance with Regulations 23.702 and 23.703, discussed below (where “Initial Margin” is defined as money, securities or property posted by a swap counterparty as performance bond to cover potential future exposures arising from changes in the market value of the position);
- 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 counterparties, as acceptable depositories for segregated Initial Margin; and
- provide information regarding the price of segregation for each such custodian (including custodial fees), to the extent the SD/MSP has such information.

The notification must be made to an officer of the counterparty responsible for the management of collateral, except that if no such officer is identified to the SD/MSP, then the notification must be made to the Chief Risk Officer, or if none exists, the Chief Executive Officer (or if none, the highest-level decision-maker) of the counterparty (the “Notice Recipient”).

Additionally, prior to confirming the terms of any such swap, the SD/MSP must obtain from the counterparty (1) confirmation that the appropriate Notice Recipient has received the Initial Margin Segregation Information and (2) its election to require such segregation or not. The SD/MSP must maintain records of this confirmation and election pursuant to Regulation 1.31.

This notification must be provided by an SD/MSP to a particular counterparty at least once per calendar year¹ (unless the SD/MSP does not enter into a swap with the counterparty during a given calendar year). However, a counterparty may, in its discretion, change its election to require or not to require segregation of Initial Margin by delivering written notice to the SD/MSP, which changed election would apply to all swaps entered into between the parties after such notice is delivered.²

In the adopting release accompanying the Final Rules (the “Release”), the CFTC notes that it may consider, in a future rulemaking, whether this notification should include information from the SD/MSP regarding the electronic platform of such SD/MSP, if any, through which counterparties may access account information on the status of their collateral.

Finally, while the CFTC clarifies in the Release that parties may negotiate segregation arrangements for variation margin, the Notification Obligation does not extend to “Variation Margin,” which is defined as a payment made by, or collateral posted by, a swap counterparty to cover the current exposure arising from changes in the market value of the position since execution of the trade or since the previous time the position was marked to market.

Segregation of Margin

The Part 23 Rules implement the Segregation Requirement by requiring that Initial Margin segregated by an SD/MSP at the request of its counterparty be maintained in an account with an independent third-party custodian, designated for that counterparty, separate from the assets and other interests of the SD/MSP.

Specifically, Regulation 23.702 requires the following:

- The custodian of Initial Margin and, if applicable, Variation Margin (collectively, “Margin”) segregated pursuant to such an election must be a legal entity “independent” of both the SD/MSP and the counterparty; and

¹ The CFTC declined to require transaction-by-transaction notification or additional notices following material changes in the cost of segregation since such repetitive notification could be overly costly and burdensome where the parties have a preexisting or ongoing relationship.

² The CFTC noted that the counterparty’s right to change such elections is appropriate since it will only apply to swaps entered into between the parties after delivery of written notice to the SD/MSP and would not have retroactive effect (unless both counterparties so agreed).

- Initial Margin segregated pursuant to such an election must be held in an account segregated for and on behalf of the counterparty and designated as such³ (which account may, if both counterparties agree, also hold Variation Margin).

In the Release, the CFTC notes that segregation will be required immediately upon the counterparty's election to require segregation, rather than delaying the effectiveness of such election until completion of the custodial documentation.

Additionally, the CFTC clarifies that the custodian selected to hold segregated Margin may be an affiliate of the SD/MSP or the counterparty, so long as the SD/MSP provides the counterparty with at least one creditworthy non-affiliate as an option to serve as the custodian, as discussed above.

Agreements for the Segregation of Margin

Regulation 23.702 also requires that any agreement for the segregation of Margin: (1) must be in writing, (2) must include the custodian as a party and (3) must provide that:

- any withdrawal of such Margin other than pursuant to a "turnover of control" of such Margin (described below) may be made only by agreement of both counterparties and notification thereof must be provided immediately to the non-withdrawing party; and
- turnover of control of such Margin will be made without the written consent of both parties, as appropriate, to the counterparty or to the SD/MSP, 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. 1746,⁴ by an authorized representative of either such party, stating that such party is entitled to such control pursuant to an agreement between the parties (and the other party must be immediately notified of such turnover). Under this provision, an SD/MSP or counterparty making a demand for collateral may avoid criminal liability if it does not engage in purposeful fraud.

In the Release, the CFTC explains that these requirements are intended to provide a balance between the interests of the SD/MSP, its counterparty and the custodian, while

³ In the Release, the CFTC clarifies that segregated Margin of each customer must be held in a separate account for such customer and may not be held by the SD/MSP in an omnibus customer account.

⁴ The CFTC notes that the perjury standard is appropriate since it mitigates the tradeoff between speed and accuracy in stress situations, such as where one party to a swap needs expedient turnover of segregated margin (*e.g.*, in order to meet margin calls on positions hedging the swap) and is unable to obtain timely approval from the counterparty (*e.g.*, since such counterparty is in financial trouble). The CFTC explains that in such circumstances it is important for a depository to be able to respond to a unilateral demand for collateral without having to take the time to investigate its legitimacy and that the perjury standard acts as a check on the legitimacy of such a demand without requiring such independent inquiry.

avoiding the necessity for time-consuming and expensive interpleader proceedings which the custodian might be forced to initiate if the SD/MSP and the counterparty make competing claims to the collateral and the agreement among the parties does not provide the custodian with a means to decide between such claims without risking legal liability.

Investment of Segregated Margin

The Part 23 Rules impose certain restrictions on the investment of segregated margin. Specifically, Regulation 23.703(a) provides that margin for uncleared swaps that is segregated pursuant to an election under Regulation 23.701 may only be invested consistent with the standards for investment of customer funds applicable to exchange-traded futures and cleared swaps under Regulation 1.25.⁵ Subject to the foregoing, the counterparties may enter into any commercial arrangement, in writing, regarding the investment of such Margin and the allocation of resulting gains and losses.

Regulation 1.25 establishes a general prudential standard used in the futures and cleared swaps markets that requires all permitted investments of customer segregated funds to be “consistent with the objectives of preserving principal and maintaining liquidity.” In the Release, the CFTC acknowledges that applying this standard to uncleared swaps may yield lower investment returns, but stresses the importance of protecting counterparties’ collateral and mitigating the systemic risk that could result from the loss of access to such collateral.

The CFTC also clarifies that where the parties to an uncleared swap have agreed to segregate both Initial Margin and Variation margin, such Margin may be commingled and held in the same account, but to the extent that the parties agree to commingle segregated Initial and Variation Margin, the requirements set forth in the Part 23 Rules, including the investment restrictions in Regulation 23.703(a), would apply to all Margin held in such account.

Requirements for Non-Segregated Margin

Section 4s(l)(4) of the CEA requires that if the counterparty does not choose to require segregation, the SD/MSP must report to the counterparty, on a quarterly basis, that the back-office procedures of the SD/MSP relating to margin and collateral requirements are in compliance with the counterparties’ agreement.

⁵ The text of Regulation 1.25 is available at:
<http://www.ecfr.gov/cgi-bin/text-idx?SID=e1d535db58ce6bed2c7d192c8d370061&node=17:1.0.1.1.0.4.24&rgn=div81>

Regulation 23.704 implements this statutory provision by requiring the chief compliance officer (“CCO”) of an SD/MSP to report to each counterparty that does not choose to require segregation of Initial Margin pursuant to Regulation 23.701(a), no later than the 15th business day of each calendar quarter, on whether the SD/MSP’s back-office procedures relating to margin and collateral requirements were, at any point during the previous quarter, not in compliance with the counterparties’ agreement. This obligation applies with respect to each counterparty no earlier than the 90th calendar day after the date on which its first swap is transacted with the SD/MSP.

The CFTC acknowledges in the Release that counterparties may choose to segregate in some lesser manner than that contemplated by Regulation 23.702, while others may choose not to segregate at all. In either case, where a counterparty to an uncleared swap does not elect to require segregation of Initial Margin in accordance with Regulation 23.702, the SD/MSP’s CCO must comply with this reporting requirement.

Part 190 Rules

The Part 190 Rules make a technical clarification with respect to section 20(c) of the CEA, which requires the CFTC to exercise its authority to ensure that, in the event of a commodity broker bankruptcy, “securities held in a portfolio margining account carried as a futures account are customer property and the owners of those accounts are customers for purposes of subchapter IV of chapter 7 of [the Code].”

In the Release, the CFTC states that it agrees with commenters that Congress, in directing the CFTC to clarify the treatment of “securities” held in a “futures account,” did not mean to imply that securities held in a “cleared swaps customer account” (as defined in Regulation 22.1)⁶ would not be treated as “customer property.”

Therefore, in order to ensure that securities held in a cleared swaps customer account receive the same bankruptcy protections as portfolio margining arrangements involving futures following a commodity broker insolvency, the Part 190 Rules make the following technical clarifications to the definitions of “customer” in Regulation 190.01(k) and “customer property” in Regulation 190.08(a)(1)(i)(F):

⁶ A “cleared swaps customer account” is an account for the cleared swaps and associated collateral of customers (*i.e.*, non-clearing members that clear swaps through a clearing member) maintained either by a futures commission merchant that is a clearing member on behalf of its customers or by a clearinghouse for the futures commission merchant that is a clearing member on behalf of its customers.

- Customer: The new definition, like the original definition, cites the definition in the Code. However, the Part 190 Rules add a clarification that, to the extent not otherwise included, “customer” includes “the owner of a portfolio margining account carried as a futures account or cleared swaps customer account.”
- Customer property: The Part 190 Rules add a provision stating that, to the extent not otherwise included, securities held in a portfolio margining account carried as a futures account or a cleared swaps customer account will be considered customer property.

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Please do not hesitate to contact us with any questions.

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