

Client update

CFTC Interpretation on Notification and Reporting Obligations of Swap Dealers and Major Swap Participants for Uncleared Swaps Margin

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On October 31, 2014, the Division of Swap Dealer and Intermediary Oversight (the “DSIO”) of the Commodity Futures Trading Commission (the “CFTC”) issued an interpretation (the “Interpretation”) of CFTC regulations 23.701 and 23.704, which impose certain notification and reporting obligations on swap dealers (“SDs”) and major swap participants (“MSPs”) with respect to initial margin posted by their counterparties in uncleared swap transactions.

The Interpretation clarifies the DSIO’s views that, subject to certain conditions:

- The Annual Margin Segregation Notification Requirement (defined below) continues to apply in any calendar year in which the SD or MSP enters into a new uncleared swap transaction with the counterparty (*i.e.*, the SD or MSP must provide the annual notice even if the counterparty has previously made an election to require segregation of initial margin);
- The Annual Margin Segregation Notification and Quarterly Reporting Requirement (defined below) are not applicable if no initial margin is required to be posted by a counterparty or collected by an SD or MSP either by contract or regulation; and
- An SD or MSP is not prohibited from relying on negative consent in complying with the Confirmation and Election Requirement (defined below).

BACKGROUND

On November 6, 2013, the CFTC adopted final rules (the “Final Rules”) implementing the requirements of, among others, section 4s(l) of the Commodity Exchange Act (the “CEA”) which sets forth certain requirements concerning the rights of counterparties of SDs and MSPs to require segregation of money, securities or other property used to margin, guarantee or otherwise

secure uncleared swaps.¹

In general, CFTC regulation 23.701(a) (the “Annual Margin Segregation Notification Requirement”) requires that, prior to the execution of an uncleared swap transaction, an SD or MSP must:

- Notify its counterparty² of its right to require that any initial margin provided in connection with such transaction be segregated;
- Identify one or more acceptable independent custodians (at least one of which must be a creditworthy financial institution that is not an affiliate of the SD or MSP); and
- Provide certain information regarding the price of segregation for each identified custodian, to the extent that the SD or MSP has such information.

CFTC regulation 23.701(e) clarifies that this notice (the “Annual Notice”) need only be made to a particular counterparty once per calendar year. The Annual Margin Segregation Notification Requirement does not apply where an SD or MSP does not enter into a swap with a counterparty during a calendar year.

In addition, CFTC regulation 23.701(d) requires that, prior to confirming the terms of any swap, the SD or MSP must obtain from the counterparty confirmation of receipt of the Annual Notice by the specified person and an election to require or not to require segregation (the “Confirmation and Election Requirement”).

Finally, CFTC regulation 23.704 requires that the chief compliance officer of an SD or MSP report quarterly to each counterparty that does not choose to require segregation of initial margin on whether the SD’s or MSP’s back office procedures relating to margin and collateral were not in compliance with the counterparties’ swap agreement at any point during the previous calendar quarter (the “Quarterly Reporting Requirement”).

INTERPRETATION

The Interpretation was provided in response to several inquiries regarding the

¹ For more information on these final rules, see our client memorandum, “Final CFTC Rules on Protection of Collateral for Uncleared Swaps and Treatment of Portfolio Margining Account in Bankruptcy,” <http://www.debevoise.com/clientupdate20131108a>

² CFTC regulation 23.701(c) specifies that such notice must be provided to an officer of the counterparty responsible for the management of collateral or, if none is identified, to certain specified officers or the highest level decision-maker of the counterparty.

practical implementation and operation of the foregoing requirements in various circumstances.

Notification Requirement When Counterparty Has Elected Segregation.

The Interpretation provides that the Annual Margin Segregation Notification Requirement is applicable regardless of whether a counterparty has previously elected segregation of its initial margin. In other words, the requirement continues to apply even where an SD or MSP has previously provided its counterparty with an appropriate Annual Notice and the counterparty elected to require segregation of its initial margin (and has not revoked such election), but only to the extent that the SD or MSP and the counterparty enter into a new swap transaction during the calendar year. The Interpretation notes that counterparties may agree that the SD or MSP will provide an Annual Notice throughout the life of their relationship, even in calendar years when no new swap is executed.³

Notification Requirement When No Initial Margin Is Required.

The Interpretation provides that the Annual Margin Segregation Notification Requirement and the Quarterly Reporting Requirement do not apply in the absence of a contractual or regulatory obligation of a counterparty to provide initial margin. In other words, under the Interpretation, where an SD's counterparty is not required (by contract or regulation) to post initial margin to the SD, the SD is not required to provide an Annual Notice to the counterparty under CFTC regulation 23.701(a) or to deliver the quarterly reports to such counterparty under CFTC regulation 23.704.

The DSIO advises SDs and MSPs to ensure that they have systems and controls sufficient to ensure that this aspect of the Interpretation is applied only in cases when no initial margin is required to be provided.

Lack of Counterparty Response to Notification.

The Interpretation responds to inquiries raised by some SDs and MSPs as to their obligation in the event they fully comply with the Annual Margin

³ As an example, the CFTC notes that if an SD enters into a relationship with a counterparty in year 1, provides the counterparty with an Annual Notice prior to entering into an uncleared swap with the counterparty (as is required), and the counterparty elects to require segregation, and if no additional uncleared swaps are entered into with the counterparty in year 2, the SD would not be required under the CFTC regulations to provide an Annual Notice in year 2.

Segregation Notification Requirement but do not receive a response from a counterparty. The DSIO clarifies that it does not believe the Confirmation and Election Requirement prohibits an SD or MSP from relying on negative consent for purposes of satisfying such requirement in the event that a counterparty fails to respond an Annual Notice appropriately provided by an SD or MSP. In other words, if a counterparty fails to respond to an Annual Notice delivered by an SD or MSP, the SD or MSP need not stop transacting with such counterparty and will be in compliance with the Confirmation and Election Requirement provided that the Annual Notice includes a prominent and unambiguous statement that failure to respond within a reasonable time period will be deemed by the SD or MSP as confirmation of receipt of the Annual Notice and an election by the counterparty not to require segregation of initial margin.⁴

This Interpretation also applies to subsequent Annual Notices sent to a counterparty. In years following the initial Annual Notice to a counterparty, while SDs and MSPs are required to continue delivering an Annual Notice to such counterparty each year a new swap is entered into with such counterparty, they need not stop transacting with a counterparty pending a new counterparty response. Rather, where a counterparty fails to respond to any subsequent Annual Notice, the SD or MSP may rely on negative consent. However, the DSIO clarifies that in cases where a counterparty fails to respond, the irrefutable presumption will be to continue segregating the counterparty's initial margin in cases where a counterparty previously elected such an option.

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Please do not hesitate to contact us with any questions.

⁴ The DSIO also reminds SDs and MSPs that they must maintain in accordance with CFTC regulation 1.31 a copy of the Annual Notice they provide to their counterparties.