
March 24, 2014

Segregation of Initial Margin for Non-Cleared Swaps

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) allows swap counterparties to require that any upfront collateral, or initial margin, collected by a swap dealer or major swap participant with respect to swaps that are not cleared through a clearinghouse (“non-cleared swaps”) be segregated at a third-party custodian. On November 6, 2013, the Commodity Futures Trading Commission (“CFTC”) published final rules imposing requirements on swap dealers and major swap participants to notify their counterparties of the right to request segregation of collateral posted to margin non-cleared swaps and providing for the treatment of such collateral if segregation is requested (the “CFTC Segregation Rule”).¹

What is Segregation?

CFTC rules require a swap dealer or major swap participant to hold a counterparty’s initial margin for non-cleared swaps in an individual account, for and on behalf of the counterparty, and separate from margin posted by other customers if requested by such counterparty. The individual account must be at a custodian that is independent of both the swap dealer or major swap participant and the counterparty. The CFTC Segregation Rule does not require swap dealers and major swap participants to offer segregation of variation margin posted to collateralize current exposure arising from the changes in the market value of a swap.

The CFTC Segregation Rule requires swap dealers and major swap participants to notify their counterparties of the right to require segregation of initial margin (the “Segregation Right Notification”). The Segregation Right Notification must be delivered at least once each calendar year to an officer at the counterparty responsible for the management of collateral. If no such officer exists or is identified, the notice may be delivered to the Chief Risk Officer, or if none, the Chief Executive Officer or the highest decision-maker for the counterparty. The swap dealer or major swap participant is required to obtain confirmation of receipt of the Segregation Right Notification and the counterparty’s election to require segregation or not prior to entering into any non-cleared swap.

¹ 17 C.F.R. Parts 23 and 190 – Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy, available at <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2013-26479a.pdf>.

Do I have to Respond to a Segregation Right Notification?

Yes. Counterparties that receive a Segregation Right Notification must respond with an election. They can choose to require segregation of initial margin or not. Swap dealers and major swap participants are required to notify their counterparties of the right to segregate and to obtain each counterparty's election. Failure to receive a response may prevent swap dealers and major swap participants from trading non-cleared swaps with the counterparty.

How do I Elect Segregation?

Following receipt of the Segregation Right Notification, market participants can inform their swap dealer and major swap participant counterparties of their election to require the segregation of initial margin through the CFTC Initial Margin Segregation module on Markit's ISDA Amend website or through a separate communication to the relevant swap dealer or major swap participant. An election to segregate initial margin will be effective with respect to all non-cleared swaps executed after the date of such election. Market participants electing to segregate initial margin will need to negotiate custody agreements with their swap counterparties and the third-party custodian and establish accounts at such custodian that comply with the CFTC Segregation Rule.

When can I Elect Segregation?

The CFTC Segregation Rule became effective on January 6, 2014. Swap dealers and major swap participants are required to offer segregation of initial margin to any new counterparties after such date by May 5, 2014. Market participants trading with a swap dealer or major swap participant prior to January 6, 2014 must be offered the right to segregate initial margin by November 3, 2014. Market participants may elect to require segregation of initial margin following receipt of the Segregation Right Notification and may change such election at any time by delivering written notice to the relevant swap dealer or major swap participant. Market participants electing to require segregation will not be able to enter into any new trades with the relevant swap dealer or major swap participant following such election until documentation and accounts compliant with the CFTC Segregation Rule are in place.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Manuel S. Frey
+1 212 373 3127
mfrey@paulweiss.com

Elanit A. Snow contributed to this client alert.