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**FREQUENTLY ASKED QUESTIONS: Receiving and Responding to Swap Dealer Notices Regarding the Right to Segregate Initial Margin Posted in Connection with Uncleared Swaps**

***Background***

The Dodd-Frank Act imposes new obligations on a swap dealer (**“*SD”***)[[1]](#footnote-2) to notify its counterparties that they have a right to require segregation of any “initial margin” (**“*IM*”**)[[2]](#footnote-3) they post in connection with uncleared swaps at an independent custodian. In October 2013 the Commodity Futures Trading Commission (**“*CFTC*”**) approved final rules (the **“*CFTC IM Segregation Rules*”**)[[3]](#footnote-4) requiring that SDs obtain (i) confirmation that the appropriate person at the counterparty received the notice and (ii) a counterparty’s election to either require or not require IM segregation in accordance with CFTC regulations 23.702 and 23.703 (the **“*CFTC IM Segregation Regime*”**).

ISDA has prepared the following list of frequently asked questions to assist market participants in receiving and responding to these SD notices and understanding some of the implications of the CFTC IM Segregation Rules. *To avoid any potential trading disruptions, market participants that receive a notice of the right to segregation of IM from an SD should respond to the request for information in such notice in a timely manner and promptly take the actions discussed below or as otherwise provided in the SD notice.*

THE “FREQUENTLY ASKED QUESTIONS” THAT FOLLOW DO NOT PURPORT TO BE AND SHOULD NOT BE CONSIDERED AN EXHAUSTIVE GUIDE TO OR EXPLANATION OF ALL RELEVANT ISSUES OR CONSIDERATIONS IN CONNECTION WITH THE CFTC IM SEGREGATION RULES. PARTIES SHOULD CONSULT WITH THEIR LEGAL ADVISERS AND ANY OTHER ADVISER THEY DEEM APPROPRIATE PRIOR TO MAKING ELECTIONS IN CONNECTION WITH THE CFTC IM SEGREGATION RULES. ISDA ASSUMES NO RESPONSIBILITY FOR ANY USE TO WHICH ANY OF ITS DOCUMENTATION OR OTHER DOCUMENTATION MAY BE PUT.

1. ***Why are SDs required to issue notices regarding a party’s right to require segregation of IM? What must these notices contain?***

CFTC regulation 23.701 requires an SD to notify a counterparty of its right to require that any IM it posts in connection with uncleared swaps be segregated in accordance with the CFTC IM Segregation Regime. The notice issued by the SD must also identify one or more acceptable independent custodians to hold IM (one of which must be a creditworthy non-affiliate) and provide information regarding the price of IM segregation to the extent that the SD has such information. This notification is required to be made by an SD to its counterparties annually.

1. ***Is segregation of IM in accordance with the CFTC IM Segregation Regime mandatory?***

No. If a counterparty receives a notice from an SD of its right to segregate IM, an election is required to be provided to the SD; however, the counterparty may elect to require segregation of IM in accordance with the CFTC IM Segregation Regime or elect not to require such segregation. As discussed further below, a counterparty may choose to preserve existing IM segregation arrangements or negotiate new arrangements that vary from the CFTC IM Segregation Regime by electing ***not*** to require IM segregation in accordance with the CFTC IM Segregation Regime.

1. ***I’ve received a notice regarding the right to segregate IM from an SD. Do I need to take any action?***

Yes.As discussed further below, counterparties that receive a notice of the right to elect IM segregation from an SD must confirm receipt of such notice and make an election to either require segregation of IM in accordance with the CFTC IM Segregation Regime or not. Failure to do so may prevent an SD from trading uncleared swaps with a counterparty. A counterparty may change its election at any time as further described in FAQ #10 below.

1. ***What specifically will market participants need to do in connection with the CFTC IM Segregation Rules?***

Market participants that receive notices relating to the CFTC IM Segregation Rules will typically be required to take the following actions:

* 1. ***Designate a “Collateral Contact”.***The CFTC IM Segregation Rules require that the notice of the right to elect IM segregation be delivered to an officer of the counterparty responsible for the management of collateral or if no such party is identified by the counterparty, the notice is to be sent to the Chief Risk Officer of the counterparty, or, if there is no such officer, the Chief Executive Officer, or if none, the highest-level decision-maker for the counterparty (a **“*Collateral Contact*”**). Because of this CFTC requirement, market participants will be asked to provide contact details for their designated Collateral Contact for purposes of annual delivery of the notice of the right to elect IM segregation. Market participants that are ISDA Amend users can designate a Collateral Contact today via ISDA Amend. See FAQ #15 below for further details.
  2. ***Confirm Receipt of the Notice.*** The CFTC IM Segregation Rules require that an SD obtain from the counterparty confirmation of receipt by its Collateral Contact of the notice from such SD of the right to elect IM segregation. Such confirmation may be made by any person authorized by the counterparty to do so.
  3. ***Provide IM Segregation Election.*** The CFTC IM Segregation Rules require that an SD obtain a counterparty’s election to require or not require that IM posted in respect of uncleared swaps be segregated in accordance with the CFTC IM Segregation Regime. Such election may be made by any person authorized by the counterparty to do so. FAQ #6 below addresses additional steps that must be taken if a counterparty elects to require IM segregation in accordance with the CFTC IM Segregation Regime.

Please note that market participants will be able to complete each of the foregoing actions via ISDA Amend. See FAQ #15 below for further details on the ISDA Amend solution.

1. ***What does it mean to segregate IM in accordance with the CFTC IM Segregation Regime?***

The CFTC has set out various parameters for its CFTC IM Segregation Regime under CFTC regulation 23.702 (Requirements for segregated margin) and CFTC regulation 23.703 (Investment of segregated margin), a few examples of which are provided below:

* The CFTC IM Segregation Regime requires that a custodial agreement provide that “turnover of control” be made “promptly” upon presentation to the custodian of a statement signed *under oath or penalty of perjury* that a party is entitled to such control.

* The CFTC IM Segregation Regime also provides that segregated IM can only be invested consistent with CFTC regulation 1.25 (which is the same standard that applies to the investment of customer funds posted in respect of exchange-traded futures and cleared swaps). This requirement is a restriction on the investment of cash margin only and does not restrict the types of collateral that a counterparty may post in connection with uncleared swaps. It may, however, prevent some custodians from offering their full suite of investment options for segregated IM.
* Other requirements address custodian eligibility, how IM must be held by the custodian and certain other required terms for the relevant custodial agreement.

1. ***If I elect to have IM segregated in accordance with the CFTC IM Segregation Regime, what steps need to be taken?***

If a counterparty elects to require IM segregation in accordance with the CFTC IM Segregation Regime, the counterparty and SD must put in place a triparty custodial agreement that meets the requirements of the CFTC IM Segregation Regime (as described further in FAQ #5 above) with an eligible custodian. After the relevant compliance date, electing to segregate IM in accordance with the CFTC IM Segregation Regime may prevent an SD from entering into new uncleared swaps until such agreement is finalized and executed.

1. ***What are the compliance deadlines for the CFTC IM Segregation Rules?***

The compliance date for a given SD-counterparty relationship depends on when the SD first entered into an agreement concerning uncleared swaps with the relevant counterparty. The compliance date for a particular counterparty can be determined by responding to the following question:

|  |  |
| --- | --- |
| **As of January 6, 2014, did an agreement concerning uncleared swaps exist between the counterparty and SD?** | **If NO**: the compliance date is **May 5, 2014**.  **If YES**: the compliance date is **November 3, 2014**. |

As discussed in further detail above, an SD must (i) obtain a counterparty’s confirmation of receipt of the notice of the right to elect IM segregation, (ii) receive the counterparty’s election whether or not to require IM segregation in accordance with the CFTC IM Segregation Regime, and (iii) should a counterparty choose to elect segregation in accordance with the CFTC IM Segregation Regime, execute with counterparty the necessary agreement(s) (such as a triparty custodial agreement) that meet the requirements of CFTC regulations 23.702 and 23.703. Consequently, market participants who receive a notice from an SD should be prepared to provide the necessary responses in advance of the applicable compliance date to avoid any potential trading disruptions.

1. ***If I have existing IM segregation arrangements or negotiations with an SD, how does my election impact such arrangements and negotiations?***

If a counterparty ***elects not to require segregation*** of IM in accordance with the CFTC IM Segregation Regime, there will be no impact on existing segregation arrangements or negotiations.

However, if a counterparty ***elects to require segregation*** of IM in accordance with the CFTC IM Segregation Regime, any existing or pending segregation arrangements will in most (if not all) cases need to be amended or replaced because they are unlikely to be consistent with the CFTC IM Segregation Regime (as described further in FAQ #5 above).

1. ***If I elect to have IM segregated in accordance with the CFTC IM Segregation Regime, how does this election impact:***
   1. ***uncleared swaps existing as of the delivery of the election?*** Existing swaps and the treatment of IM posted in respect of these swaps will not be affected (unless the SD and counterparty agree otherwise).
   2. ***uncleared swaps executed after the delivery of the election?*** The election will be applicable to IM posted in respect of uncleared swaps executed after the delivery of the election to the relevant SD (unless the election is delivered before the relevant CFTC compliance date, in which case the election will become applicable to IM posted in respect of uncleared swaps executed on or after the applicable CFTC compliance date).
2. ***Once the applicable CFTC compliance date has passed, can I change my CFTC IM segregation election?***

Yes. An IM segregation election may be changed at the discretion of the counterparty upon written notice to the SD at any time, and any such changed election will be applicable to all uncleared swaps entered into between the parties after delivery of such changed election. An IM segregation election may also be changed prior to the applicable CFTC compliance date, but elections made prior to such date will only impact uncleared swaps entered into on or after the relevant compliance date.

1. ***Do the CFTC IM Segregation Rules address how much IM is required?***

No. The CFTC IM Segregation Rules do not address how much IM is required, who must post IM, or what types of collateral will be permitted to be posted as IM in respect of uncleared swaps.

1. ***Do the CFTC IM Segregation Rules grant counterparties the right to require segregation of collateral posted in respect of variation margin?***

No. The CFTC IM Segregation Rules do not grant counterparties the right to segregate variation margin.

1. ***Special Considerations for Investment Advisers/Asset Managers.***

Investment advisers/asset managers delivering an IM segregation election on behalf of a counterparty may be asked to provide a representation as to their authority to do so.  If an investment adviser/asset manager executes and delivers an election letter on behalf of a counterparty, then the relevant election will only apply to uncleared swaps that are executed by such manager as agent on behalf of such counterparty.

1. ***Is there an ISDA Protocol associated with the CFTC IM Segregation Rules?***

No.

1. ***What is ISDA doing to facilitate the notice process?***

ISDA and Markit are providing additional tools on ISDA Amend to assist market participants in designating Collateral Contacts, delivering/receiving the relevant notices regarding the right to IM segregation, confirming receipt of such notices, and making elections regarding whether to segregate IM in accordance with the CFTC IM Segregation Regime. These tools will be available at no cost to non-dealer market participants.

Market participants that wish to take advantage of the ISDA Amend platform for designating their Collateral Contacts and managing their responses to SD notices should onboard onto ISDA Amend as soon as possible if they are not already ISDA Amend users.

The ISDA Amend tool for designating Collateral Contacts and delivering Collateral Contact information to SDs is currently available for use. Market participants wishing to use ISDA Amend are encouraged to use this tool well in advance of the applicable compliance deadline. The ISDA Amend tools for delivery/receipt of the relevant notices regarding the right to IM segregation, confirmations of receipt and communication of segregation elections are in development, and are expected to be available in late April 2014.

**Special Note for “new counterparties” to whom the May 5, 2014 compliance deadline is applicable (see FAQ #7 above):** Such counterparties should consider whether they will have sufficient time to complete the necessary steps described in FAQ #4 (and FAQ #6, if applicable) if they wait for the full suite of ISDA Amend tools to be available. If sufficient time may not be available, the counterparty should deliver their confirmations and elections directly to SDs in order to avoid any trade disruptions on or after May 5, 2014. Such counterparties may still use the current ISDA Amend tool to deliver Collateral Contact information to SDs so that SDs may deliver the necessary notices to the appropriate person.

ISDA and Markit will provide further announcements as development of these new tools on ISDA Amend is completed.

1. The obligations imposed on swap dealers, as described in these Frequently Asked Questions, also apply to “major swap participants” (as defined in CFTC rules).  Given that there are no functioning major swap participants as of the date of publication of these FAQs, these FAQs focus solely on the obligations imposed on swap dealers for the sake of simplicity. [↑](#footnote-ref-2)
2. ISDA’s Credit Support Annexes use the term “Independent Amount” rather than “initial margin”. [↑](#footnote-ref-3)
3. *Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy*, 78 Fed. Reg. 66621 (Nov. 6, 2013) (adopting CFTC Regulations 23.700-23.704); available at <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2013-26479a.pdf>. [↑](#footnote-ref-4)