

Segregation of Initial Margin Posted in Connection with Uncleared Swaps: Considerations for the Buy Side

Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act and Commodity Futures Trading Commission (“CFTC”) Rules 23.702 and 23.703 thereunder (together, the “Rules”), swap dealers are required to notify their counterparties that they have the right to require segregation with a third-party custodian of any initial margin (also known as “independent amounts”) posted to the swap dealer in connection with uncleared swaps. As a result of these new rules, the International Swaps and Derivatives Association (“ISDA”) recently published a [form of notification](#) and a set of [frequently asked questions](#) regarding these rules. All buy-side entities that trade in uncleared swaps with swap dealers (including buy-side entities that already post their margin with a third-party custodian, such as registered investment companies, and buy-side entities that do not post initial margin) should receive a copy of the notification from their swap dealer counterparties in the coming weeks or months and should plan to respond promptly to the notification in order to avoid any trading disruptions.

Under the new rules, swap dealers are required to (i) notify each counterparty to any swap transaction that the counterparty has the right to require that any initial margin the counterparty provides in connection with such transaction be segregated with an independent custodian; (ii) obtain the counterparty’s confirmation of receipt of the notice of the right to elect segregation; (iii) receive the counterparty’s election regarding segregation of initial margin; and (iv) if the counterparty elects to segregate initial margin in accordance with the Rules, execute a triparty custody agreement or similar agreement with the counterparty that meets the requirements of the Rules. In the notice, the swap dealer is required to identify one or more independent custodians that the counterparty may select to hold initial margin, and to provide pricing information to the extent the swap dealer has such information. The swap dealer has no obligation to offer as a possible custodian the counterparty’s custodian for other purposes; the swap dealer only has to offer a custodian of its choice that is not affiliated with the swap dealer.

Buy-side counterparties may choose one of several options in response to the notice:

- Counterparties that do not currently segregate initial margin and wish to begin doing so should make this election upon receipt of notice from their swap dealer counterparties. These counterparties will need to negotiate and execute a triparty custodial agreement among the counterparty, the swap dealer and the applicable custodian that is consistent with the Rules, in advance of the applicable compliance date noted below.
- Counterparties that already have arrangements to segregate initial margin that they wish to preserve may continue to rely on those arrangements and should elect not to require segregation of initial margin in accordance with the Rules. The terms of the counterparty’s existing arrangements with the swap dealer to segregate initial margin are not expected to be impacted by the Rules or by the counterparty’s election not to segregate in accordance with the Rules. We expect that many counterparties with existing arrangements will continue to use those arrangements and will not elect to segregate under the new regime.
- Counterparties that already have arrangements to segregate initial margin that want to update their arrangements to be consistent with the new regime should elect to do so upon receipt of notice from their swap dealer counterparties. These counterparties will need to amend or replace their existing triparty custodial agreements to be consistent with the Rules.

- Counterparties that do not wish to segregate initial margin and counterparties that do not provide initial margin should elect not to require segregation of initial margin in accordance with the new regime.

Unless the parties otherwise agree, the election will apply to new uncleared swaps entered into after the applicable compliance date noted below. A counterparty can always change its election by notifying the dealer, in which case the revised election will apply to new uncleared swaps entered into after such revised election is made.

The Rules impose certain requirements with respect to segregation of initial margin that are inconsistent with typical current terms for tri-party account agreements. These include a requirement that the triparty custodial arrangement provide that collateral in the triparty account may be released upon instruction of one party to the arrangement (*i.e.*, either the swap dealer or the counterparty) “promptly” upon submission to the custodian of a written statement “made under oath or under penalty of perjury” stating that such party is entitled to exercise control over the account. Additionally, funds in the triparty account may only be invested consistent with CFTC Rule 1.25 (*e.g.*, in certain “highly liquid” securities, including certain government securities, certificates of deposit, and money market funds).

Segregation of initial margin may provide certain benefits to buy-side counterparties. Holding initial margin in a triparty account generally is expected to provide additional credit protection with respect to the collateral in the event of an insolvency of the swap dealer. Buy-side entities will need to evaluate whether the benefits of segregating initial margin outweigh the costs.

ISDA and Markit have indicated that they will provide additional tools on ISDA Amend to allow buy-side market participants to designate an appropriate contact person to receive notices, to receive and confirm receipt of the relevant notices, and to make elections. The tools are expected to be fully functional in late April 2014. As a result, we expect that many swap dealers subject to the May 5, 2014, compliance deadline described below may contact their counterparties outside of the ISDA Amend process in order to avoid trading disruptions.

Compliance Dates. Swap dealers (and therefore their buy-side counterparties) are required to be in compliance with CFTC Rules 23.702 and 23.703:

- By **May 5, 2014**, with respect to any counterparty that entered into a new agreement with the swap dealer concerning uncleared swaps after January 6, 2014; and
- By **November 3, 2014**, with respect to any counterparty that had an agreement with the swap dealer concerning uncleared swaps as of January 6, 2014.

Swap dealers are required to annually provide the notice to, and to obtain an election from, their counterparties.

Please contact the Ropes & Gray attorney who usually advises you with any questions.