



## Financial Services & Products ADVISORY ■

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### **Segregation of Margin for Uncleared Swaps Under Dodd-Frank: Practical Considerations for the Customer**

As required by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Commodity Futures Trading Commission (CFTC) has adopted a rule (the "Rule") for segregation of margin and collateral (both referred to in this note as "margin") for uncleared swaps.<sup>1</sup> The Rule applies to initial margin posted by a customer with a swap dealer or major swap participant (SD/MSP), but not to margin posted with any other kind of market participant. Under the Rule, initial margin must be segregated in a third-party custodial arrangement if requested by the customer. As discussed below, segregation may protect customers in the event of an SD/MSP insolvency, but it also raises issues each customer should consider before choosing to segregate.

The Rule became effective on January 6, 2014. The SD/MSP's deadline for compliance with the Rule is not until June 6, 2014 for new customer relationships (relationships for which an agreement governing uncleared swaps was not in place on January 6, 2014) and January 6, 2015 for existing customer relationships (relationships for which an agreement governing swaps was in place on January 6, 2014).

#### **Scope of the Rule**

As noted above, a customer's right to segregation of margin extends only to initial margin for uncleared swaps with SD/MSPs.

*Initial margin.* The Rule contains a somewhat technical definition of initial margin, but broadly speaking, the concept is aligned with margin posted by the customer in excess of its swap obligations and also with the "Independent Amount" posted by the customer under an ISDA Credit Support Annex.<sup>2</sup> Under the U.S.

<sup>1</sup> The Rule is published at 78 Fed. Reg. 66621 (November 6, 2013). The relevant statutory provision is Section 4s(l) of the Commodity Exchange Act, 7 U.S.C. Section 6s(l).

<sup>2</sup> Initial margin is defined in the Rule as "money, securities, or property posted by a party to a swap as performance bond to cover potential exposures arising from changes in the market value of the position."

Bankruptcy Code and U.S. bank insolvency laws, margin posted by a swap counterparty *up to* the amount of its swap obligations is not at risk if the other party becomes insolvent because margin and outstanding swap obligations can generally be netted without permission from the bankruptcy court or a bankruptcy official. Absent segregation, however, the excess margin is at risk, and the solvent party may have only an unsecured claim against the insolvent party for the amount of the excess margin. The Rule gives the customer the opportunity to protect its excess margin by requiring the SD/MSP to segregate the excess margin at a third-party custodian if the customer requests.

Although the right to segregation applies only to initial margin, the parties can agree to segregate the remainder of margin posted. A customer may want to consider segregation of all its margin if the SD/MSP's insolvency scheme restricts netting of margin and swap obligations once an insolvency proceeding has commenced.

*Uncleared swaps.* Uncleared swaps may include swaps that are not yet subject to a clearing mandate from the CFTC and also swaps for which the customer claims the end-user exception. Currently, only certain categories of interest rate swaps and certain categories of credit default swaps are subject to a clearing mandate, but the CFTC will almost certainly adopt clearing mandates for other types of swaps. The end-user exception is limited to market participants and transactions that meet the conditions in the CFTC's end-user exception rule.<sup>3</sup>

*SD/MSP as counterparty.* The universe of registered SD/MSPs is publicly available on the National Futures Association's website.<sup>4</sup> Registration by one entity in a family of companies does not convey SD/MSP status on any of its affiliates. Consequently, the customer's right to segregation does not apply to initial margin posted for swaps with an affiliate of an SD/MSP unless the affiliate is also an SD/MSP.

### **Notification of Customer's Right to Segregation**

The Rule requires the SD/MSP to provide each of its customers written notice of the customer's right to segregation of initial margin for uncleared swaps. The SD/MSP must also obtain written confirmation that the customer received the segregation notification together with the customer's decision as to whether it will exercise its right to segregation. At any time, the customer may change its decision on whether its initial margin should be segregated.

### **The Custodian**

If the customer elects to segregate its initial margin, the margin must be held at an independent custodian in a separate account designated as an account segregated for and on behalf of the customer. The SD/MSP's notice must identify one or more potential custodians to hold segregated margin. Each potential custodian must be a legal entity separate from the SD/MSP and the customer, and at least one must be a creditworthy custodian not affiliated with the SD/MSP. The Rule is not explicit on whether the customer has the right to identify a custodian or whether it must choose from the custodians specified by the SD/MSP. The CFTC's discussion in the release published with the Rule appears to accommodate the customer's desire to make its own recommendation. However, if the SD/MSP resists the customer's independent choice, then (unless the

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<sup>3</sup> The CFTC's end-user exception rule is at 17 C.F.R. Part 50.50.

<sup>4</sup> <http://www.nfa.futures.org/NFA-swaps-information/regulatory-info-sd-and-msp/SD-MSP-registry.html>.

customer is willing to challenge the SD/MSP through formal proceedings) the customer will have to consider whether one of the custodians identified by the SD/MSP can provide meaningful protection.

### **Cost of Segregation**

The Rule is silent as to which party pays the cost of the custodial arrangement, although it is likely the customer will pay, whether directly or indirectly. As a practical matter, the cost of segregation may include (i) the custodian's fees and (ii) higher swap transaction fees or higher charges set by the SD/MSP for trading relationships in which it cannot use (rehypothecate) the initial margin. The SD/MSP is required by the Rule to disclose the "price associated with segregation" to the extent it is known to the SD/MSP. That price includes custodial fees, but the CFTC does not elaborate on what else should be included in the pricing information. Customers may have to ask the SD/MSP for details of all costs associated with the custodial arrangement (including any increase in SD/MSP fees or charges) and look for some assurance from the SD/MSP that all such costs have been disclosed. The customer will then have to determine whether the added protection from segregation justifies the higher transaction costs.

### **Custody Agreement**

The Rule requires the third-party custodial relationship to be documented in a written custody agreement. The segregated property can be released to one party or the other either (i) upon the agreement of both the customer and the SD/MSP or (ii) upon a written statement of one party that the party is entitled to control of the property under an agreement between the customer and the SD/MSP. The statement must be signed by the party's authorized representative "under penalty of perjury." The requirement that the written statement be "under penalty of perjury" is an attempt to balance the need of the parties to obtain the margin quickly in some circumstances (for example, in the event of a default) and the need to protect against improper requests to gain access to the margin. Determining the circumstances under which the custodian may comply with a customer request for return of margin will likely be a point of contention between the SD/MSP and the customer. The customer should not assume its margin will be returned as soon as the customer asserts that the SD/MSP has defaulted. If the SD/MSP challenges the customer's default determination, it could be some time before the issue is resolved. During that time, the customer may not have access to its property.

### **Investment of Segregated Margin**

Although the statute makes no reference to investment of segregated margin, the Rule specifies that any investment of segregated margin must comply with the CFTC's Regulation 1.25. That Regulation requires investments to be made with the general objectives of preserving principal and maintaining liquidity. Investments must be highly liquid, and limitations are imposed on the types of investments and the concentration and average remaining maturity of the investments. If a customer wants margin invested according to parameters that are inconsistent with Regulation 1.25, the customer should consider whether segregation provides sufficient benefits to justify the deviation from its preferred investment guidelines.

### **Non-Segregated Margin**

If the customer does not elect segregation, the SD/MSP must deliver to the customer quarterly reports affirming that the SD/MSP's back office procedures have complied at all times during the quarter with the

parties' agreement. The customer may also want to include in its swap agreement (if the SD/MSP will agree) remedies to address the SD/MSP's failure to provide periodic reports or failure to follow its internal procedures. Customer remedies could include the right to terminate swaps, the return of its margin upon request and/or receipt of compensation.

## Timing

The decision whether to segregate margin for uncleared swaps involves a number of considerations. Each customer will have to assess the issues based on its individual circumstances. If the customer decides to go forward with segregation, the customer should bear in mind that negotiating the custodial agreement and related provisions in the swap documentation may take some time to complete.

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