



## U.S. COMMODITY FUTURES TRADING COMMISSION

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### Division of Swap Dealer and Intermediary Oversight

CFTC Letter No. 14-132  
Interpretation  
October 31, 2014  
Division of Swap Dealer and Intermediary Oversight

### **Re: Staff Interpretation Regarding the Notification of Right to Segregation of Initial Margin in Uncleared Swap Transactions and Quarterly Reporting under Commodity Futures Trading Commission Regulations 23.701 and 23.704**

#### **Introduction**

The Division of Swap Dealer and Intermediary Oversight (“Division”) of the Commodity Futures Trading Commission (“Commission”) is issuing this interpretation of Commission Regulations 23.701 and 23.704,<sup>1</sup> which impose certain notification and reporting obligations on swap dealers (“SDs”) and major swap participants (“MSPs”) with respect to margin posted by their counterparties in uncleared swap transactions. The interpretation clarifies the Division’s views that:

- (1) The requirement under Regulation 23.701 that an SD or MSP must provide annual notification to each counterparty to an uncleared swap transaction of such counterparty’s right to elect to require segregation of initial margin<sup>2</sup> continues to apply in any calendar year in which the SD or MSP enters into a new uncleared swap transaction with the counterparty. The SD or MSP is required to provide the annual notification whether or not the counterparty previously made an election to require the SD or MSP to segregate initial margin;
- (2) the annual notification and quarterly reporting requirements set forth in Regulations 23.701 and 23.704 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

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<sup>1</sup> The Commission’s regulations may be found at 17 CFR Chapter I, and also are available through the Commission’s website, [www.cftc.gov](http://www.cftc.gov).

<sup>2</sup> The term “initial margin” is defined in Regulation 23.700 and for purposes of this Interpretation to mean “money, securities, or property posted by a party to a swap as performance bond to cover potential future exposures arising from changes in the market value of the position.”

- (3) An SD or MSP is not prohibited from relying on negative consent in complying with its obligations under Commission Regulation 23.701(d) to obtain from its counterparty (a) confirmation of the counterparty's receipt of the annual notice provided by the SD or MSP under Regulation 23.701 and (b) the counterparty's election to require or not require segregation. The Division's interpretation is subject to the conditions discussed below.

### **Regulatory Background**

On November 6, 2013, the Commission adopted final rules implementing the requirements of, among others, Section 4s(l) of the Commodity Exchange Act (the "Act"),<sup>3</sup> 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.<sup>4</sup> Compliance with the new regulations adopted by the Commission was required no later than May 5, 2014, with respect to uncleared swap transactions entered into with "new counterparties"<sup>5</sup> and is required no later than November 3, 2014, with respect to uncleared swap transactions entered into with "existing counterparties."<sup>6</sup>

In general, Regulation 23.701(a) requires that, prior to the execution of an uncleared swap transaction, an SD or MSP must:

- (1) Notify its counterparty that the counterparty has the right to require that any initial margin provided in connection with such transaction be segregated;
- (2) 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
- (3) Provide certain information regarding the price of segregation for each identified custodian, to the extent that the SD or MSP has such information.

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<sup>3</sup> 7 U.S.C. § 1 *et seq.* The Act may also be accessed through the Commission's website.

<sup>4</sup> Section 724(c) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act") amended the CEA to add section 4s(l).

<sup>5</sup> A "new counterparty" is defined as a counterparty with whom, at the time of the effective date of the final rules, no agreement existed between the SD or MSP and that counterparty concerning uncleared swaps. Protection of Collateral of Counterparties of Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy, 78 Fed. Reg. 66621, n. 1 (Nov. 6, 2013) [hereinafter, "Protection of Collateral"].

<sup>6</sup> An "existing counterparty" is defined as a counterparty with whom, at the time of the effective date of the final rule, an agreement existed between the SD or MSP and that counterparty concerning uncleared swaps. *Id.*

Regulation 23.701(c) specifies to whom such notice must be provided – i.e., 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. Regulation 23.701(d) requires that prior to confirming the terms of any swap, the SD or MSP obtain from the counterparty confirmation of receipt of the notice by the specified person and an election to require or not to require segregation. Regulation 23.701(e) clarifies that the notice required under Regulation 23.701(a) need only be made once in any calendar year. Further, 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 swap agreement of the counterparties at any point during the previous calendar quarter.

### **Request for Interpretation**

The Division has received several inquiries regarding the practical implementation of the Commission's regulations and believes it is appropriate to provide general guidance regarding the operation of the rules in various circumstances. Specifically, the Division has received inquiries regarding:

- (1) The applicability of the annual notification requirement under Regulation 23.701 when a counterparty has received notice of its right to require segregation of initial margin, has elected to require such segregation, and has not revoked such election;
- (2) The applicability of the notification and report requirements in Regulations 23.701 and 23.704, respectively, in the absence of a contractual or regulatory requirement for the posting of initial margin by a counterparty; and
- (3) The obligations of an SD or MSP under Regulation 23.701(d) in the event it does not receive a response after providing notice to an appropriate representative of the counterparty.

These issues are discussed further below.

### **Staff Position**

#### **1. Annual notice requirement when counterparty has previously chosen segregation**

As noted above, the Division has received an inquiry as to whether the annual notification requirement set forth in Regulations 23.701 is applicable to an SD or MSP if the SD or MSP previously provided its counterparty with appropriate notification under the regulation, the counterparty elected to require segregation of its initial margin, and the counterparty has not revoked such election.

Regulation 23.701(a) requires not only that an SD or MSP provide its counterparty with notice of its right to require segregation of initial margin, but also that, in conjunction therewith, the SD or MSP inform the counterparty of one or more acceptable independent custodians, including at least one creditworthy non-affiliate of the SD or MSP, and provide certain information regarding the price of segregation for each custodian, to the extent that the SD or MSP has such information. Information about available custodians and costs may change over time and is relevant to a counterparty's decision-making process. An SD or MSP may enter into relationships with additional or alternative custodians after notification was provided with respect to the initial swap transaction and information regarding the price of segregation for each custodian is of continued relevance.

The Commission also addressed this point in the Federal Register release adopting its regulations ("Adopting Release")<sup>7</sup>, stating that "[a]nnual notification ... reduces the likelihood that required information regarding custodians and pricing will become obsolete, which would be a significant possibility if notification were given only at the beginning of a multi-year business relationship between the counterparty and the SD or MSP."<sup>8</sup> The Adopting Release also states, however, that "where an SD or MSP does not enter into a swap with a counterparty during a calendar year, the notification requirement would not apply."<sup>9</sup> Accordingly, the Division believes that the annual notification requirement set out in Regulation 23.701 is applicable whether or not a counterparty has previously chosen segregation of its initial margin. However, the Division further clarifies that the annual notification is applicable only to the extent that the SD or MSP and the counterparty enter into a new swap transaction during the calendar year.<sup>10</sup> Of course, counterparties may agree that the SD or MSP will provide annual notification throughout the life of their relationship, even in calendar years when no new swap transaction is executed.

As an example of the above, assume an SD enters into a relationship with a counterparty in year 1 and enters into an uncleared swap transaction with such counterparty. Prior to entering into the transaction, the SD would be required to provide notification to the counterparty of its right to have its initial margin segregated in accordance with Commission regulations. Further, assume that the counterparty elects to avail itself of its right of segregation.<sup>11</sup> In year 2, if no additional uncleared swap transactions are entered into with the counterparty, the SD would not

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<sup>7</sup> Protection of Collateral, 78 Fed. Reg. 66621.

<sup>8</sup> *Id.* at 66625.

<sup>9</sup> *Id.*

<sup>10</sup> See 17 CFR 23.701(e).

<sup>11</sup> Regulation 23.701(d) requires that prior to confirming the terms of any uncleared swap, the SD or MSP must obtain from its counterparty confirmation of receipt of the notification required under Regulation 23.701(a) and the counterparty's election as to whether or not it wishes to require segregation. This confirmation and election must be maintained as business records pursuant to Regulation 1.31.

be required under Commission regulations to provide a notification.<sup>12</sup> If, however, in year 2 or in a subsequent year the SD enters into another uncleared swap transaction with the counterparty, prior to entering into the transaction the SD would be required to again provide notification under the regulations.

## 2. Notification when no initial margin is required

The Division also has received inquiries as to the applicability of Regulations 23.701 and 23.704 in the absence of a contractual or regulatory obligation of a counterparty to provide, or of a SD or MSP to collect, initial margin in connection with uncleared swap transactions. In such circumstances, the inquirers have suggested that providing a notice of a right that cannot be exercised may be confusing to the counterparty and, assuming the SD or MSP has no counterparties from whom it collects initial margin, would result in additional costs for and burden on the SD or MSP with no related benefit.<sup>13</sup> Specifically, it was suggested that costs and burdens could include, among others, establishing a compliance framework, identifying non-affiliate custodians, ascertaining relevant custodian costs, processing notice elections and updating the notice annually.

Section 4s(1) of the CEA and Regulation 23.701(b) provide that the segregation right notification requirement in uncleared swap transactions does not apply to variation margin payments. Thus, the notification requirement applies only to initial margin.<sup>14</sup> Regulation 23.701 provides specifically that an SD or MSP must provide to each counterparty to an uncleared swap transaction notification that such counterparty “has the right to require that *any Initial Margin the counterparty provides in connection with such transaction* be segregated . . . .”<sup>15</sup> In other words, the question is whether the notification is required in all cases or only if the counterparty must, in fact, provide initial margin in connection with a swap transaction.

Similarly, Regulation 23.704, which implements Section 4s(1)(4) of the CEA, provides that if a counterparty to an uncleared swap transaction does not choose to require segregation, the SD or MSP must report quarterly to the counterparty whether the SD’s or MSP’s back office procedures relating to margining and collateral requirements were, at any time in the previous quarter, not in compliance with the agreement of the parties. In the event that no initial margin is required from a counterparty, staff has received inquiries whether such quarterly report should be required.

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<sup>12</sup> As noted above, however, the parties may agree on their own that notification will be provided annually whether or not a new swap has been transacted.

<sup>13</sup> For the avoidance of doubt, the term “required” as used in this interpretation includes any case in which initial margin is collected by the SD or MSP, including where the posting of initial margin is at the election of the counterparty.

<sup>14</sup> See Protection of Collateral, 78 Fed. Reg. at 66621.

<sup>15</sup> Emphasis added.

The Division agrees that when no initial margin will be required, either by contract or regulation, there is no apparent benefit to requiring notice as set forth in Regulation 23.701, and the Division believes that the regulation was not intended to require notice under such circumstances. The Division also agrees that to require notification to a counterparty with respect to a right to segregate funds when no such funds are required to be provided as part of the transaction could prove confusing and, in certain circumstances, add unnecessary costs. SDs and MSPs are advised to ensure that they have systems and controls sufficient to ensure that this interpretation is applied only in cases when no initial margin will be required. An SD or MSP would be fully liable for any failure to follow the requirements of Regulation 23.701 when initial margin may be collected from a counterparty.

Similarly, the Division does not believe that Regulation 23.704 was intended to be applicable in the event that no initial margin will be required as part of a swap transaction. The statute and the regulation ensure through quarterly reporting that a counterparty that has provided initial margin but whose funds are not segregated is nonetheless kept informed of whether its funds are being handled by the SD or MSP in the manner in which the parties envisioned, as set forth in their swap agreement. In the event that no initial margin is provided as part of the transaction, such reporting is not necessary.

Further, the Division believes that a technical reading of the regulations suggests that no quarterly reporting requirement exists in the event that no initial margin is provided. The quarterly reporting obligation under Regulation 23.704 is triggered if a counterparty “does not choose” to require segregation of initial margin. The regulation appears to presume some affirmative action on the part of the counterparty in making a choice not to exercise a right to require the SD or MSP to segregate. As noted above, in an uncleared swap transaction where initial margin is to be provided and the SD or MSP must provide notification to the counterparty under Regulation 23.701(a) of its right to require segregation of those funds, the SD or MSP is required to obtain an affirmative or negative election from the counterparty under Regulation 23.701(d) as to whether or not the counterparty chooses to require such segregation. In other words, the counterparty either chooses to require segregation or does not choose to require segregation. In a transaction where no initial margin is provided and, therefore, no notification of a right to segregate is given, the counterparty would not make an election. Absent a choice or election (whether explicit or implicit) on the part of the counterparty, the Division does not believe that any obligation exists under the rule.

### **3. Lack of Counterparty Response to Notification**

SDs and MSPs have inquired as to their obligation in the event they fully comply with the notification requirement set forth in Regulation 23.701 but do not receive a response from a counterparty. As noted, Regulation 23.701(d) requires that an SD or MSP obtain from the counterparty confirmation that an appropriate person at the counterparty has received notification from the SD or MSP and an election from the counterparty regarding whether or not segregation

of initial margin will be required. The SD or MSP is required to maintain records of such confirmation and election as business records in accordance with Regulation 1.31.<sup>16</sup>

Concerns have been raised by some SDs and MSPs that, notwithstanding an earnest effort to obtain such confirmation and election, failure by the counterparty to respond could result in the inability to execute any further swap transaction and remain in compliance with the regulations, effectively mandating a transaction “blackout” period with the counterparty until a response is received. The Division appreciates these concerns and does not believe the regulation intended to place such a limitation on SDs and MSPs.

The Division does not believe that the Regulation prohibits an SD or MSP from relying on negative consent for purposes of 23.701(d) in the event that a counterparty fails to respond to notification appropriately provided by an SD or MSP in accordance with Regulations 23.701(a) and (c). That is, in the event that a counterparty does not respond to a notice provided in accordance with the agreement of the parties regarding the receipt of notices, the Division believes that an SD or MSP will have fulfilled its obligation under Rule 23.701(d) provided that the notice under Regulation 23.701(a) 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 notice and an election by the counterparty not to require segregation of initial margin for purposes of the Commission’s Regulations.<sup>17</sup> Staff notes that an SD or MSP must maintain in accordance with Regulation 1.31 a copy of the notification it provides to its counterparty in accordance with Regulation 23.701(a).

SDs and MSPs have raised similar concerns of a potential “blackout period” in the context of subsequent annual notifications. They have requested comfort that in years following the initial notice and election under Commission regulations they need not stop transacting with a counterparty pending a new counterparty response. Again, staff does not believe the intent of the regulation is to impose a trading restriction on SDs and MSPs pending a counterparty response. As discussed above, SDs may, provided appropriate notification and absent a counterparty response, rely on negative consent. However, given the emphasis in the statute placed on the right of a counterparty to require segregation of its initial margin, staff believe that the negative consent presumption in cases where a counterparty fails to respond should be toward the continuation of segregation in cases where a counterparty previously elected such an option.

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<sup>16</sup> 17 CFR 1.31.

<sup>17</sup> Staff appreciates that some SDs or MSPs may have provided notice to counterparties under Regulation 23.701(a) prior to the date of this Interpretation and that such notice would not have included a statement regarding negative consent. In such case, an SD or MSP may satisfy this requirement and therefore avoid any disruption in trading by providing a supplemental notice containing the specified negative consent language to the representative at the counterparty to whom the original notice was delivered. The supplemental notice should be provided to counterparties promptly after publication of this Interpretation.

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This letter represents the position of the Division only and does not necessarily represent the views of the Commission or those of any other division or office of the Commission. Should you have questions regarding this matter, please contact Lawrence Eckert, Special Counsel (leckert@cftc.gov, 646-746-9704) or Thomas Smith, Deputy Director (tsmith@cftc.gov, 202-418-5495).

Very truly yours,

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