



COMMODITY FUTURES TRADING COMMISSION

17 CFR Part 23

RIN 3038–AE78

Segregation of Assets Held as Collateral in Uncleared Swap Transactions

AGENCY: Commodity Futures Trading Commission.

ACTION: Final rule.

SUMMARY: The Commodity Futures Trading Commission (“Commission” or “CFTC”) is amending selected provisions of its regulations to simplify certain requirements for swap dealers (“SDs”) and major swap participants (“MSPs”) concerning notification of counterparties of their right to segregate initial margin for uncleared swaps, and to modify requirements for the handling of segregated initial margin.

DATES: Effective [INSERT DATE 30 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER].

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I. Introduction

A. Existing Requirements

1. Statutory Basis and Regulatory Background

Subpart L of part 23 of the Commission’s regulations (“Segregation of Assets Held as Collateral in Uncleared Swap Transactions,” consisting of Regulations 23.700 through 23.704) was published in the *Federal Register* on November 6, 2013 and became effective on January 6, 2014.¹ Subpart L implements the requirements for segregation of initial margin for uncleared swap transactions set forth in section 4s(l) of the Commodity Exchange Act (“CEA” or the “Act”).²

CEA section 4s(l) addresses segregation of initial margin held as collateral in certain uncleared swap transactions. The section applies only where a swap between a counterparty and an SD or MSP is not submitted for clearing to a derivatives clearing organization (“DCO”). It requires that an SD or MSP notify the counterparty of the SD

¹ See 78 FR 66621 (Nov. 6, 2013).

² 7 U.S.C. 6s(l) (2012 and Supp. 2015). Like the Commission’s regulations, the CEA can be accessed through the Commission’s website.

or MSP at the beginning of a swap transaction that the counterparty has the right to require segregation of the funds or other property supplied to margin, guarantee, or secure the obligations of the counterparty. Such funds or property are to be segregated in a separate account from the SD's or MSP's assets. The separate account must be held by an independent third-party custodian and must be designated as a segregated account for the counterparty. CEA section 4s(l) does not preclude the counterparty and the SD or MSP from agreeing to their own terms regarding investment of initial margin (subject to any regulations adopted by the Commission) or allocation of gains or losses from such investment. If the counterparty elects not to require segregation of margin, the SD or MSP is required to report quarterly to the counterparty that the SD's or MSP's back office procedures relating to margin and collateral are in compliance with the agreement between the counterparty and the SD or MSP.

In November 2015, the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the Federal Housing Finance Agency (collectively, "Prudential Regulators") adopted margin requirements for swaps entered into by SDs and MSPs that they regulate ("Prudential Regulator Margin Rules").³ In January 2016, the Commission adopted margin requirements for certain uncleared swaps which requirements are applicable to SDs and MSPs for which there is no prudential regulator ("CFTC Margin Rule").⁴ The CFTC Margin Rule and the Prudential Regulator Margin Rules established initial and variation margin requirements for SDs and MSPs.⁵

³ See Margin and Capital Requirements for Covered Swap Entities, 80 FR 74840 (Nov. 30, 2015).

⁴ Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 FR 636 (Jan. 6, 2016). The CFTC Margin Rule, which became effective April 1, 2016, is codified in part 23 of the

Prior to the CFTC Margin Rule effective date of April 1, 2016, if initial margin⁶ was to be exchanged by counterparties to uncleared swaps involving an SD or MSP, the requirements of subpart L applied. The CFTC Margin Rule amended Regulation 23.701 to clarify that from and after the effective date of the CFTC Margin Rule, the requirements of Regulations 23.702 and 23.703 would not apply where segregation is mandatory under the CFTC Margin Rule.⁷ As a result, Regulations 23.702 and 23.703 generally apply only when initial margin is to be exchanged between an SD or MSP and either: (1) a nonfinancial end-user, or (2) a financial end-user without “material swaps exposure,” as defined in the CFTC Margin Rule.

2. Subpart L as Originally Adopted

Regulation 23.700, as originally adopted, defines certain terms used in subpart L. Regulation 23.701 requires an SD or MSP: (1) to notify each counterparty to a swap that is not submitted for clearing that the counterparty has the right to require that any initial margin it provides be segregated; (2) to identify a creditworthy custodian that is a non-affiliated legal entity, independent of the SD or MSP and the counterparty, to act as depository for segregated margin assets; and (3) to provide information regarding the costs of such segregation. The regulation specifies that the notification is to be made (with receipt confirmed in writing) to an officer of the counterparty responsible for

Commission’s regulations. 17 CFR 23.150 through 23.159, 23.161. The Commission also adopted a rule addressing margin in the cross-border context. *See* 17 CFR 23.160.

⁵ *See* 17 CFR 23.151.

⁶ The Commission notes that the term “Initial Margin” is used only for purposes of subpart L of the Commission’s regulations.

⁷ 81 FR at 704. The amendment did not address the application of subpart L to swaps subject to mandatory segregation under the Prudential Regulator Margin Rules. As described *infra*, this Proposal would clarify that the swaps subject to the Prudential Regulator Margin Rules are to be addressed in the same manner as swaps subject to the CFTC Margin Rule.

management of collateral (or to specified alternative person(s)), and that it need only be made once in any calendar year. Finally, the regulation provides that a counterparty can change its election to require (or not to require) segregation of initial margin by written notice to the SD or MSP.

Regulation 23.702 reiterates the requirement that the custodian be a legal entity independent of the SD or MSP and the counterparty. It also requires that segregated initial margin be held in a designated account segregated for, and on behalf of, the counterparty. Finally, the regulation specifies that the segregation agreement must provide that: (1) withdrawals from the segregated account be made pursuant to agreement of both the counterparty and the SD or MSP, with notification to the non-withdrawing party; and (2) the custodian can turn over segregated assets upon presentation of a sworn statement that the presenting party is entitled to control of the assets pursuant to agreement among the parties.

Regulation 23.703 restricts investment of segregated assets to investments permitted under Regulation 1.25 and (subject to that restriction) permits the SD or MSP and the counterparty to agree in writing as to investment of margin and allocation of gains and losses.

Regulation 23.704 requires the SD's or MSP's chief compliance officer ("CCO") to report quarterly to any counterparty that does not elect to segregate initial margin, whether or not the SD's or MSP's back office procedures regarding margin and collateral requirements were, at any point in the previous calendar quarter, not in compliance with the agreement of the counterparties.

B. Factors Considered by the Commission

Over the course of more than four years of administering subpart L of part 23, the Commission has observed that the detailed requirements of those regulations have proven difficult for SDs and MSPs to implement and to satisfy in a reasonably efficient manner. These observations were buttressed by suggestions submitted in response to the Commission's "Project KISS" initiative as described herein. In addition, the Commission understands that very few swap counterparties have exercised the right to elect to segregate initial margin collateral pursuant to subpart L during the four years that the regulations have been effective.

Early in the implementation period, in response to multiple inquiries, Commission staff issued CFTC Staff Letter 14-132 (October 31, 2014),⁸ which provided interpretative guidance to SDs and MSPs regarding application of certain of the segregated margin requirements. In particular, the letter noted concerns expressed by SDs and MSPs that despite their earnest efforts to obtain confirmation of receipt of notification and election regarding segregation, failure by a counterparty to respond to the SD or MSP could bar any further swap transactions with the counterparty until a response was received.⁹ However, notwithstanding the issuance of Staff Letter 14-132, issues regarding compliance with subpart L continue to be raised.¹⁰

⁸ See CFTC Staff Letter No. 14-132 (October 31, 2014), available at <https://www.cftc.gov/sites/default/files/idc/groups/public/@lrllettergeneral/documents/letter/14-132.pdf>.

⁹ The Proposal aimed to address generally some of the confusion that prompted the issuance of CFTC Staff Letter 14-132, *supra* n.8, in the context of other changes to subpart L that were proposed.

¹⁰ For example, issues regarding compliance with these regulations have been raised with the National Futures Association as recently as January 2018, indicating ongoing uncertainty. See pp. 6-7 of the transcript of the NFA Swap Dealer Examination Webinar, January 18, 2018, available at <https://www.nfa.futures.org/members/member-resources/files/transcripts/sdexamswebinartranscriptjan2018.pdf>.

On May 9, 2017, the Commission published in the *Federal Register* a request for information,¹¹ pursuant to the Commission’s “Project KISS” initiative, seeking suggestions from the public for simplifying the Commission’s regulations and practices, removing unnecessary burdens, and reducing costs. A number of suggestions the Commission received addressed various provisions of subpart L. In general, those suggestions echoed Commission staff concerns that the requirements in subpart L may be more burdensome than is necessary to achieve the purposes of the statute and may be counterproductive to the extent that they frustrate the decision making process and discourage the use of individual segregation accounts.¹² Persons responding to Project KISS also noted that some requirements cause confusion because they overlap with segregation requirements in the margin regulations recently adopted by the CFTC and Prudential Regulators.¹³ Furthermore, responders stated that the requirements in subpart L are overly prescriptive, eliminating the possibility for reasonable bilateral negotiation that takes place in the normal course to determine certain terms, including appropriate

¹¹ See 82 FR 21494 (May 6, 2017) and 82 FR 23765 (May 24, 2017).

¹² See, e.g., letter from the Financial Services Roundtable (“FSR Letter”), dated September 30, 2017 at 55 (noting that “compliance with these regulations has proven to be unduly burdensome for swap dealers when weighed against the protections afforded to swap counterparties thereunder”), available at [https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=61427&SearchText=.](https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=61427&SearchText=)

¹³ *Id.* See also letter from the Securities Industry and Financial Markets Association (“SIFMA Letter”) dated September 29, 2017 at 2 (“These requirements create unnecessarily burdensome obligations, which in many instances are duplicative or create confusion due to parallel mandatory collateral segregation requirements found within the CFTC and [prudential regulator] rules on margin requirements for non-centrally cleared swaps, and similar requirements in foreign jurisdictions.”), available at [https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=61359&SearchText=.](https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=61359&SearchText=)

collateral arrangements based on the circumstances of the broader counterparty relationship.¹⁴

Responders also asserted that counterparties to uncleared swaps rarely elect to require segregation of margin pursuant to the existing provisions of subpart L.¹⁵ Commission staff likewise has observed evidence of minimal exercise of the election to segregate.¹⁶ In addition, Commission staff has discussed this issue with the National Futures Association (“NFA”) to ascertain NFA’s observations from examining a substantial number of SDs in connection with the implementation of subpart L. Based on this experience, it appeared that for nearly every SD examined, fewer than five counterparties elected segregation pursuant to subpart L since registration. For some SDs, not a single counterparty elected to segregate pursuant to subpart L.

In light of these considerations, the Commission proposed to amend the regulations governing segregation of margin for uncleared swaps (the “Proposal”).¹⁷ The Commission expressed its belief that the proposed amendments would reduce unnecessary burdens on registrants and market participants by simplifying some overly detailed provisions, thereby reducing the intricate and prescriptive requirements. The Commission further opined that the proposed changes would facilitate more efficient swap execution by eliminating complexity and confusion that slows down documentation

¹⁴ See SIFMA Letter at 2. See also letter from the Global Foreign Exchange Division of the Global Financial Markets Association (“GFMA Letter”) dated September 29, 2017, available at: <https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=61414&SearchText=>.

¹⁵ See FSR Letter at 55 (“Our members have advised that counterparties (1) rarely, if ever, elect to segregate [initial margin] and (2) have found little use for receiving the notices.”).

¹⁶ See 83 FR 36484, 36486 (Jul. 30, 2018).

¹⁷ See “Segregation of Assets Held as Collateral in Uncleared Swap Transactions,” 83 FR 36484 (Jul. 30, 2018).

and negotiation of hedging and other swap transactions. Finally, the Commission asserted that the amendments, by reducing the prescriptive elements of the rules, potentially could encourage more segregation (as was intended by the CEA),¹⁸ by providing flexibility for the parties to establish segregation arrangements that better suit their specific needs.

In the preamble to the Proposal, the Commission also sought comment from the public on the appropriateness of the proposed changes, as well as suggestions for other amendments that could streamline, simplify, and reduce the costs of subpart L without sacrificing the protections called for by CEA section 4s(l). The comment period for the Proposal closed on September 28, 2018, and four comment letters¹⁹ were received: one from a swap dealer;²⁰ one from a registered futures association;²¹ one from an association of credit risk professionals in the energy industry;²² and one jointly submitted by a trade organization for participants in over-the-counter derivatives markets and a trade organization for broker-dealers, investment banks, and asset managers.²³

II. The Final Rule, Summary of Comments, and Commission Response

The Commission is adopting changes to Regulations 23.700, 23.701, 23.702, 23.703, and 23.704 as proposed. In Regulation 23.700, the definition of “Margin” is

¹⁸ 83 FR at 38486. *See also* 75 FR 75432, 75433 (Dec. 3, 2010) (noting the important right for a counterparty to elect segregation “with a certain degree of favor given to an affirmative election”).

¹⁹ The comment letters may be accessed via the Commission’s website at <https://comments.cftc.gov/PublicComments/CommentList.aspx?id=2898>.

²⁰ Letter from INTL FC Stone Markets, LLC, Sept. 27, 2018 (“IFCS”).

²¹ Letter from National Futures Association, Sept. 28, 2018 (“NFA”).

²² Letter from International Energy Credit Association, Sept. 28, 2018 (“IECA”).

²³ Letter from International Swaps and Derivatives Association and Securities Industry and Financial Markets Association, Sept. 27, 2018 (“ISDA/SIFMA”).

eliminated (and where that term was used elsewhere in subpart L it is replaced with “Initial Margin”). In Regulation 23.701, the following changes are made: (1) the required notification of the right to segregate is to be made at the beginning of the first uncleared swap transaction that provides for exchange of initial margin; (2) the exception to the notification requirement in cases where segregation is required under the CFTC Margin Rule is expanded to include cases where segregation is required under Prudential Regulator Margin Rules; (3) the annual notification requirement is eliminated; (4) the requirement to identify in the notification one or more creditworthy custodians and to provide information regarding the cost for segregation for each named custodian is eliminated; (5) the requirement to provide the notification to a person with specific job title at the counterparty is eliminated; (6) the terms of segregation are to be established by written agreement with the counterparty; and (7) the requirement to obtain from the counterparty and maintain written confirmation of receipt of the notification is eliminated. In Regulation 23.702, specific requirements regarding the withdrawal or turnover of control of initial margin are replaced with a provision that the segregation agreement provide that instructions to withdraw initial margin be in writing and that withdrawal notification be given immediately to the non-withdrawing party. In Regulation 23.703, the restriction on investment of segregated margin to investments permitted under Regulation 1.25 is eliminated. In Regulation 23.704, the requirement that the SD’s or MSP’s CCO report quarterly to each counterparty that does not elect segregation is replaced by a general requirement that the SD or MSP so report, and that the report must state that the SD’s or MSP’s back office procedures were in compliance with the agreement of the counterparties.

All of the commenters generally supported the Proposal and the Commission's efforts to simplify and rationalize the existing requirements. Comments that addressed particular provisions of subpart L will be discussed below.

A. Regulation 23.700 – Definitions

As proposed, the Commission is amending Regulation 23.700 to eliminate the definition of “Margin” and to make conforming changes to subpart L by replacing the term “Margin” with “Initial Margin” in Regulations 23.701, 23.702, and 23.703. As originally adopted, Regulation 23.700 defines “Margin” as “both Initial Margin and Variation Margin.”²⁴ As amended, subpart L will no longer refer collectively to initial margin and variation margin, because the right to require segregation applies only to initial margin, and not to variation margin. Thus, there is no need for the separate defined term “Margin.”²⁵

IECA was the only commenter to address this issue and asked the Commission to revise the defined terms to relate more closely to over-the-counter market terms by clarifying whether or not Initial Margin is analogous to a deposit. IECA pointed out that independent amounts are often posted not to secure changes in market position but to protect settlement risk, and that variation margin is an exchange of collateral and not a “payment” in exchange for something.²⁶ In the adopting release for subpart L, the Commission considered several comments questioning its selection of defined terms and it adopted the “initial margin” definition notwithstanding those comments, noting that

²⁴ See 17 CFR 23.700.

²⁵ The Commission is also adopting a grammatical change for the definition of the term “segregate” (the words “*Segregate*. To segregate two or more items is to keep them in separate accounts . . .” were replaced with “*Segregate* means to keep two or more items in separate accounts . . .”).

²⁶ IECA at 3-5.

“variation margin” is used in the statute and “initial margin” is the obvious complementary term.²⁷ After review of the comments, the Commission confirms the rationale it articulated for proposing the amendments to Regulation 23.700, and therefore, is adopting the amendments as proposed.

B. Regulation 23.701 – Notification of right to segregation

As proposed, the Commission is amending paragraph (a) of Regulation 23.701: (1) to require that the notification to a counterparty be made prior to execution of the first uncleared swap transaction that provides for the exchange of initial margin, and not prior to each transaction; (2) to provide that the notification obligation does not apply where segregation is required under Prudential Regulator Margin Rules; (3) to eliminate the requirement that the notification identify one or more creditworthy, independent custodians; and (4) to eliminate the requirement to provide information regarding the price for segregation for each identified custodian. Paragraph (b) remains unchanged. The Commission is replacing paragraph (c) with a simple statement that if segregation is elected, the terms shall be established by written agreement and eliminating paragraphs (d) and (e) (with existing paragraph (f) redesignated as new paragraph (d)). As discussed below, after review of the comments, the Commission confirms the rationale articulated for proposing the amendments to Regulation 23.701, and therefore, is adopting the amendments as proposed.

As originally adopted, paragraphs (a) and (b) of Regulation 23.701 direct an SD or MSP to notify each counterparty to an uncleared swap of the right to require

²⁷ See 78 FR at 66623. The Commission considered a range of comments, including that “Initial Margin” was too broad or too narrow, or that “independent amount” should be used instead (or at least tracked or referenced), before concluding that “Initial Margin” was the most practical choice under the circumstances.

segregation of initial margin. Paragraph (c) requires the SD or MSP to furnish the required notification to an officer of the counterparty responsible for management of collateral, or, if no such person is identified by the counterparty, then to the chief risk officer, or, if there is no such officer, to the chief executive officer, or if none of the foregoing, the highest-level decision-maker for the counterparty. Paragraph (d) requires the SD or MSP, “prior to confirming the terms of any such swap,” to obtain confirmation of receipt of the notification and the counterparty’s election to require or not require segregation of initial margin (such confirmation to be retained in accordance with Regulation 1.31).²⁸ Paragraph (e) provides that the notification need be made only once in any calendar year.²⁹ Finally, paragraph (f) provides that the counterparty may change the segregation election at its discretion by providing a written notice to the SD or MSP.

Based on staff’s implementation experience and on suggestions received in connection with Project KISS, the Commission expressed in the preamble to the Proposal its belief that these requirements are unnecessarily prescriptive and that they do not reflect the practical realities of how over-the-counter swap transactions are negotiated and managed by the parties. Accordingly, the Commission proposed to modify the notification requirement in paragraph (a) and to remove the requirements in existing paragraphs (c), (d), and (e). The Commission did not propose to amend paragraph (f) except to redesignate it as paragraph (d).³⁰

²⁸ 17 CFR 1.31.

²⁹ Some confusion has been caused by the requirement in paragraph (d) to provide the notice “prior to confirming the terms of any such swap,” and the requirement in paragraph (e) to provide the notice once in any calendar year. *See* SIFMA Letter at 3.

³⁰ *See* 83 FR at 36486-88.

The Commission proposed to revise paragraph (a) to require that the notification to a counterparty be made prior to execution of the first uncleared swap transaction that provides for the exchange of initial margin,³¹ not prior to each transaction or annually as currently prescribed by paragraphs (a) and (e).³² CEA section 4s(l)(1)(A) requires notification of the right to segregate “at the beginning of a swap transaction.” The Commission stated that it was interpreting that phrase to mean at the beginning of an SD’s or MSP’s swap transaction relationship with each counterparty.³³

This interpretation is an extension of the view the Commission expressed when it originally proposed and adopted Regulation 23.701. Specifically, with respect to the statutory requirement that notification be provided “at the beginning of a swap transaction,” the Commission noted that “[w]hile this language could be read to require transaction-by-transaction notification, where the parties have a pre-existing or on-going relationship, such repetitive notification could be redundant, costly, and needlessly burdensome. On the other hand, the importance of the segregation decision, as discussed above, suggests that some periodic reconsideration might be appropriate.”³⁴ The Commission then noted that the decision to require an annual notice was an attempt to balance the interests of ensuring that counterparties know of their segregation rights against inundating them with redundant information. The Commission, now, based on its experience, has determined that this is not the right balance, and in fact, it has not observed any significant use of segregation. As the Commission noted in 2013, the

³¹ This revision is consistent with guidance provided in CFTC Staff Letter 14-132, *supra* n.8.

³² Thus, under the Proposal, paragraph (e) of Regulation 23.701 (providing that the notification need only be made once in any calendar year) would become unnecessary, and was proposed to be deleted.

³³ *See* 83 FR at 36487.

³⁴ *See* 78 FR at 66625.

statute “does not merely grant counterparties the legal right to segregation; it specifically requires that the existence of this right be communicated to them.”³⁵ These rule amendments adopted herein still ensure that the rights imparted under CEA section 4s(l) are communicated to SD/MSP counterparties while limiting the burden of providing and receiving superfluous notifications.

When it originally adopted Regulation 23.701(e), the Commission considered comments requesting a loosening of the once-per-year notice requirement and rejected the requests in the belief that requiring notification once each year would balance the burden of providing notices and getting responses with the importance of the right to segregate initial margin.³⁶ However, on the basis of implementation experience since Regulation 23.701 was originally adopted, the Commission proposed to require notification at the beginning of a swap trading relationship that provides for exchange of initial margin. The importance of the notification informing the counterparty of the right to segregate is paramount at the beginning of the SD/MSP-counterparty relationship. It is at the time the parties initiate the first transaction that the decision to segregate initial margin will typically be made.³⁷ Subsequent notifications, in addition to the initial notification, risk adding confusion over the duration of the contractual relationship between the parties.³⁸ In this regard, the Commission stated its understanding that counterparties rarely change their election, once made. Accordingly, in addition to

³⁵ *Id.*

³⁶ *Id.*

³⁷ For existing master netting agreements for which the SD has already sent a segregation notice, the Commission took the view in the preamble to the Proposal that such notice would be sufficient for purposes of complying with the amended regulations, if adopted, and therefore the SD would not be required to send a new notice.

³⁸ See FSR Letter at 55, *supra* n.12 See also, *supra* n.10.

modifying the notification requirement in paragraph (a), the Commission proposed to eliminate paragraph (e)'s annual notification requirement in light of the proposed obligatory notification at the beginning of the first uncleared swap transaction that provides for exchange of initial margin.

The Commission also proposed that paragraph (a) be revised to eliminate the notification requirement where segregation is mandatory under Regulation 23.157 and where it is mandated under applicable rules adopted by a Prudential Regulator under CEA section 4s(e)(3). Additionally, paragraph (a)(2) (the requirement that the notification identify one or more creditworthy, independent custodians) was proposed to be deleted because selection of a custodian can be made when and if the counterparty elects to require segregation. Because very few counterparties elect to require segregation, the Commission stated that it is unnecessarily burdensome to require an SD or MSP to confirm which custodians are available and continually update the SD's or MSP's notification form with the name of the custodian(s) available. Moreover, the Commission further understood that a counterparty's initial decision to consider requiring (or not requiring) segregation is driven principally by the counterparty's concern about protecting its initial margin and the terms of the segregation agreement, and not by the identity of the custodian.³⁹ Similarly, the Commission proposed to delete paragraph (a)(3) (information regarding the price for segregation for each custodian) because such pricing may vary for each segregation arrangement and would normally be subject to negotiation. To the extent pricing would be a factor in the decision to segregate,

³⁹ See 83 FR at 36487.

counterparties can and do discuss pricing as a term of the custodial arrangement when the counterparty indicates an interest in segregation.⁴⁰

Similarly, the Commission proposed to eliminate the requirement in paragraph (c) that the SD or MSP provide the notification to a person at the counterparty with a specific job title. Based on implementation experience, the Commission expressed the view that the regulation as initially adopted is unnecessarily prescriptive in dictating who must receive the notification. For example, in many cases, the person at the counterparty best situated to evaluate the notification and the decision to segregate will be a person directly involved in negotiating the swap, regardless of that person's title. The Commission notes that in removing the specific designation of officers to receive the notification it would not be eliminating the expectation that each registrant will use reasonable judgment in identifying an appropriate person at the counterparty who can evaluate the right to elect segregation (and either act on it or bring it to the attention of someone in a position to act on it). The Commission stated its continued belief that, to be effective, the notification must be made to a person at the counterparty who understands its meaning and, to the extent necessary, can direct it to the appropriate personnel at the counterparty. The proposed change sought to advance the same underlying policy objective as the existing requirement (namely that the notification be given to appropriate personnel at the counterparty), but would recognize that dictating how counterparties communicate the information in question creates unnecessary burdens and potentially hinders the ability of the parties to direct the information to the person(s) best situated to evaluate it.⁴¹

⁴⁰ *Id.* The Commission also notes that the requirements in paragraphs (a)(2) and (a)(3) are not found in CEA section 4s(l).

⁴¹ *Id.*

As proposed, new paragraph (c) would simplify requirements in existing Regulation 23.701 by providing that “[i]f the counterparty elects to segregate initial margin, the terms of segregation shall be established by written agreement.”⁴²

As noted above, the Commission proposed to eliminate the additional requirements in existing paragraph (d), which are more extensive than the notification requirements set forth in CEA section 4s(l). Subsequent to adoption of subpart L, experience with implementation of the requirements of Regulation 23.701 has made the Commission aware of problems experienced by registrants in complying with these additional requirements. For example, persons seeking guidance have noted that paragraph (d)’s current requirement that the SD not execute a swap with the counterparty until it receives confirmation of the counterparty’s receipt of the notification has the potential to block swap trading in some circumstances.⁴³ Instances of forestalled trading caused by this requirement could be particularly harmful for nonfinancial end-users that have ongoing, dynamic hedging programs (to hedge, for example, commodity price risk or foreign exchange risk).⁴⁴

The Commission observed that compliance with the existing segregation notification requirements in the regulation necessitates lengthy explanations and instructions from SDs and MSPs to their counterparties and imposes additional administrative processes requiring counterparties to take steps that are outside of the normal course of transacting in swaps. Some of these steps cause transaction delays and

⁴² *Id.*

⁴³ *See* 83 FR at 36487. *See also* CFTC Staff Letter 14-132, *supra* n.8.

⁴⁴ *See* IECA Letter at 8 (commenting that the proposed interpretation of CEA section 4s(l)(1)(A) is reasonable given the commercial realities of uncleared swaps transactions and relationships between SDs and MSPs and their counterparties).

deviations from established business procedures for collateral custodial arrangements and disclosure of counterparty rights generally, and do not advance the counterparty's right to segregate initial margin. For nonfinancial end-user counterparties who tend to use swaps primarily for hedging purposes, these added compliance steps often cause confusion and uncertainty that can inhibit opportune, timely hedging. For counterparties that execute swaps frequently and have determined that they wish to segregate, the additional requirements merely add unnecessary hurdles to the transaction process. Accordingly, the Commission stated that it does not believe that the burdens imposed by these prescriptive requirements provide meaningful regulatory benefits beyond those provided by the provisions in proposed amended Regulation 23.701.⁴⁵

Several commenters generally supported the amendments to Regulation 23.701. NFA stated that it supports the Commission's efforts to clarify and simplify these requirements, and that "[b]ased on our experience, we believe that eliminating a segregation notice requirement under these circumstances would help reduce unnecessary correspondence and avoid confusion."⁴⁶ IFCS stated that "the current notification requirements often cause confusion to [their] customers – requiring the Firm to respond with lengthy explanations – rather than providing any meaningful benefit."⁴⁷ Two other commenters supported eliminating the segregation notice requirement where segregation is mandatory under rules of a Prudential Regulator, asserting that this will help reduce unnecessary correspondence and avoid confusion.⁴⁸ In response to a question in the

⁴⁵ See 83 FR at 36487-36488.

⁴⁶ NFA at 2.

⁴⁷ IFCS at 2.

⁴⁸ NFA at 1-2; *accord* ISDA/SIFMA at 3.

Proposal, IECA stated that the Commission's proposed interpretation of the notification requirement in CEA section 4s(l)(1)(A) is reasonable given the commercial realities of uncleared swaps transactions and relationships between SDs and MSPs and their counterparties.⁴⁹

Because drafting and exchange of relationship documentation can occur well before the first transaction, ISDA/SIFMA sought confirmation that notification of the right to segregate may be given at any time prior to the first transaction,⁵⁰ and further confirmation that trading can continue during any interim period between a counterparty's election to segregate initial margin and the execution of related documentation.⁵¹ The Commission is declining at this time to specify what constitutes the beginning of the first swap transaction or to proscribe when trading may commence because it believes that the counterparties are best able to determine those parameters under their specific circumstances. IECA asked the Commission to provide that the notification can be part of the relationship documentation, noting that the personnel who negotiate, review, and execute relationship documentation are appropriate personnel to understand and act upon such a notification.⁵² The Commission notes that although the statute does not specify the manner in which the required notification must be provided, a reasonable interpretation would require that it be sufficiently conspicuous to draw the counterparty's attention.

⁴⁹ IECA at 8.

⁵⁰ ISDA/SIFMA at 3-4.

⁵¹ *Id.* at 4.

⁵² IECA at 5-6.

Three commenters specifically supported elimination of the existing requirement to notify counterparties annually of the right to require segregation. IFCS stated that “customers have indicated that they find little use for receiving a Segregation Notice on an annual basis,” pointing to “the administrative burdens associated with providing the notice on an annual basis coupled with its lack of utility” in supporting elimination of the requirement.⁵³ NFA added that if the Commission retains the annual notification requirement, it should eliminate it where counterparties have previously elected to require segregation, noting that very few counterparties have, over time, changed their initial election.⁵⁴ Because the Commission is eliminating this requirement, NFA’s comment is moot. In response to a question in the Proposal, IECA urged that the Commission provide that there is no need for a swap dealer to provide any such notice unless or until there is initial margin in the swap trades between the two parties.⁵⁵ In response, the Commission notes that the language of CEA section 4s(l) does not condition the obligation to notify on the actual tender of initial margin. Additionally, in response to a question, IECA stated that the Commission should not provide that the counterparty may request or opt to continue to receive notification at the beginning of each swap transaction or an annual or some other periodic basis.

IFCS expressly supported elimination of the requirement to include information about the price of custody services in the notification of the right to require segregation, stating that “[c]osts associated with segregation are largely controlled by the third-party custodian and may vary for each segregation agreement, which, together, make it difficult

⁵³ IFCS at 2; *accord* IECA at 2 and NFA at 2.

⁵⁴ NFA at 2.

⁵⁵ IECA at 8.

to provide meaningful pricing information in the notification.”⁵⁶ All commenters supported elimination of the requirement to provide the required notification to a specified individual, noting that SDs and counterparties are best able to determine an appropriate recipient for the notification.⁵⁷ IECA noted that by eliminating the requirement to obtain and keep a confirmation of the counterparty’s receipt of the notification of right to require segregation, over-the-counter market participants will save significant costs and avoid risk and confusion. Specifically, IECA stated that “[s]wap trades are documented on ‘confirmations.’ The current rule calls two different things ... ‘confirmations’ as necessary for swap trades,”⁵⁸ and also pointed out that “[t]he notice and ‘confirmation’ mechanisms may also conflict with corporate resolutions, and agreement representations, regarding who is authorized to trade for the counterparty.”⁵⁹ IECA also stated that proposed paragraph (d) of Regulation 23.701 should be replaced with language that permits a counterparty to knowingly choose to waive in their master agreement the right to require segregation under CEA section 4s(l)(1)(B), and that also permits the counterparty to waive the right to be notified that it can require segregation.⁶⁰ The Commission believes that the amendments it is adopting provide sufficient flexibility (e.g., eliminating the requirement to provide notification prior to each swap), and observes that including a waiver mechanism would appear to be inconsistent with Congressional intent as expressed in CEA section 4s(l) (i.e., that counterparties to

⁵⁶ IFCS at 2.

⁵⁷ IFCS at 2; ISDA/SIFMA at 3; NFA at 2; *accord* IECA at 2.

⁵⁸ IECA at 2.

⁵⁹ *Id.*

⁶⁰ *Id.* at 6-7.

uncleared swaps be provided with affirmative notification of the right to elect segregation).

C. Regulation 23.702 – Requirements for segregated initial margin

As proposed, the Commission is amending paragraph (c) of Regulation 23.702 to replace the specific requirements in subparagraphs (1) and (2) regarding withdrawal or change in control of margin with a requirement “that any instruction to withdraw Initial Margin shall be in writing and that notification of the withdrawal shall be given immediately to the non-withdrawing party.” As adopted, Regulation 23.702 sets forth requirements for the custody of initial margin segregated pursuant to a counterparty’s election under Regulation 23.701. Paragraph (c)(2) of Regulation 23.702 provides specific requirements for the withdrawal and turnover of control of initial margin. In particular, paragraph (c)(2) requires the custodian to turn over control of initial margin upon presentation of a written statement made by an authorized representative under oath or under penalty of perjury as specified in 28 U.S.C. 1746. Such statement must provide that the person presenting it is entitled to assume control of the initial margin pursuant to the parties’ agreement. The other party must be immediately notified of the turnover of control. As discussed below, after review of the comments, the Commission confirms the rationale articulated for proposing the amendments to Regulation 23.702, and therefore, is adopting the amendments as proposed.

In the Proposal, the Commission expressed its belief that, while paragraph (c)(2) may generally be consistent with the manner in which custodial arrangements work, the prescriptive requirements of the regulation, including requiring a specific form, the language used, and the certification needed, do not account for change in control

arrangements in custodial agreements that are sometimes customized to reflect the unique business facts and circumstances that may exist between any two parties and the custodian. For example, the unique nature of the collateral posted or the specific terms of change in control triggers may warrant different notice procedures than those specified by paragraph (c)(2). Alternative notice procedures may allow for more timely and effective change in control under real-world circumstances and better protect each party's interests. Accordingly, the Commission said it believed that more flexibility is warranted, and that it is more appropriate to leave these matters up to negotiation by the parties.⁶¹

IFCS specifically expressed support for the proposed amendments to Regulation 23.702.⁶² IFCS stated that it “believes the current regulations are overly prescriptive and welcomes the opportunity for bilateral negotiations between sophisticated market participants who are, by definition, deemed to be able to protect their own interests.”⁶³ Another commenter suggested a change to existing paragraph (c)(2).⁶⁴ However, because the Commission is eliminating that paragraph, the comment is moot.

In response to a question in the Proposal regarding whether the Commission should adopt in Regulation 23.702(a) more specific financial or affiliation qualifications for the custodian that an SD or MSP uses as a depository for segregated initial margin, IECA stated that it should not, and added that if the Commission wishes to educate counterparties on custodian credit characteristics and risks, it could hold roundtables from

⁶¹ See 83 FR at 36488.

⁶² IFCS at 3.

⁶³ *Id.*

⁶⁴ IECA at 7.

time to time and publish the transcripts.⁶⁵ The Commission is retaining the requirement that a custodian be a legal entity independent of both the SD or MSP, and the counterparty. It does not believe that a roundtable is necessary at this time.⁶⁶

D. Regulation 23.703 – Investment of segregated initial margin

As proposed, the Commission is amending Regulation 23.703 to eliminate the requirement that investment of margin that is segregated pursuant to an election under Regulation 23.701 may only be done in a manner consistent with Regulation 1.25. As originally adopted, Regulation 23.703 requires initial margin segregated pursuant to subpart L to be invested consistent with Regulation 1.25.⁶⁷ Paragraph (b) provides that, subject to consistency with Regulation 1.25, the SD or MSP and the counterparty may enter into any commercial arrangement, in writing, regarding the investment of margin and allocation of resulting gains and losses. Regulation 1.25 sets forth standards for investment of customer funds by a futures commission merchant (“FCM”) or DCO in the context of exchange-traded futures and cleared swaps. When originally proposing Regulation 23.703, the Commission expressed its view that Regulation 1.25 “has been designed to permit an appropriate degree of flexibility in making investments with segregated property, while safeguarding such property for the parties who have posted it, and decreasing the credit, market, and liquidity risk exposures of the parties who are relying on that margin.”⁶⁸ As discussed below, after review of the comments, the

⁶⁵ IECA at 8-9.

⁶⁶ If, in the future, the Commission becomes aware of problems resulting from poorly selected custodians it will consider hosting a roundtable or other appropriate outreach to remedy any such issues.

⁶⁷ 17 CFR 1.25.

⁶⁸ See 75 FR at 75434.

Commission confirms the rationale articulated for proposing the amendments to Regulation 23.703, and therefore, is adopting the amendments as proposed.

A suggestion in response to the Project KISS initiative noted that Regulation 1.25 is designed to protect exchange customers for which margin investment decisions are outside of their control.⁶⁹ Regulation 1.25 includes fairly extensive and specific requirements as to the mechanisms for holding and investing margin and the qualitative aspects of the investments held. With respect to initial margin for uncleared swaps that is not held in accordance with Regulation 23.157 or with the Prudential Regulator Margin Rules, the margin investment decisions are typically a matter of contract subject to negotiation between the parties. As such, each counterparty has a voice in how the initial margin may be invested.⁷⁰

In addition, the terms of most exchange-traded and cleared products are standardized and the customer's primary relationship with the FCM or DCO centers upon the trading and clearing of those standardized products. Conversely, over-the-counter swaps, by their nature, tend to be more customized and are often part of a broader financial relationship. For example: interest rate swaps with end-users are often designed to match maturities of loans or bonds, with the rate of the swap tied to the rate on the loan or bond; commodity swaps often hedge the counterparty's physical commodity production or consumption risks that arise from a particular commercial enterprise; and foreign exchange swaps often hedge an entity's exposure to cross-border commercial transactions. In each case, the SD or MSP sometimes plays additional

⁶⁹ See SIFMA Letter at 4.

⁷⁰ See 83 FR at 36488.

financial roles, such as brokering physical commodity purchases or sales, providing a loan or other credit or liquidity support, or acting as a correspondent bank. Accordingly, each counterparty, particularly nonfinancial end-user counterparties, may find better transactional efficiencies and may be better served and protected in related credit transactions if the types of collateral and the investment procedures and mechanisms used are determined through bilateral negotiation by the parties.⁷¹

In the preamble to the Proposal, the Commission stated that, given the greater breadth and variability, both in the terms and purposes of uncleared swaps and in the nature of the relationship between the counterparty and the SD or MSP, a regulation that provides greater flexibility for the parties to negotiate appropriate initial margin investment terms will, in most cases, better serve the parties' interests. For the same reasons, allowing greater flexibility may also encourage more counterparties to elect to segregate pursuant to subpart L.⁷²

The Commission also recognized that in some circumstances, nonfinancial end-user counterparties might have less negotiating leverage with a sophisticated SD or MSP.⁷³ However, the regulations as originally adopted give little or no flexibility for counterparties and SDs or MSPs to negotiate mutually beneficial terms and to consider other factors such as the broader financial relationship between the parties. For nonfinancial end-user counterparties, the segregation of initial margin is at their discretion. If these counterparties have a voice in how segregated initial margin is

⁷¹ See 83 FR at 36488.

⁷² *Id.*

⁷³ *Id.*

invested, the returns of which they will often receive, they may be more likely to elect to require segregation.⁷⁴

ISDA/SIFMA stated that “[b]y taking steps to remove unnecessary requirements regarding annual notices, disclosures and Rule 1.25 limitations which prevent counterparties from negotiating preferred terms regarding the investment of segregated collateral, among other proposed amendments, the Commission is furthering its goal to streamline overly burdensome rules in a manner more consistent with market practice, while still achieving its regulatory oversight objectives.”⁷⁵ IFCS supported the Proposal’s “allowance for more flexibility in the requirements for segregated margin and investment of segregated margin,” describing the existing requirements as overly prescriptive and welcoming the opportunity for bilateral negotiations between sophisticated market participants.⁷⁶ In response to the Commission’s question regarding how the requirement that margin that is segregated pursuant to an election under Regulation 23.701 may only be invested consistent with Regulation 1.25 has impacted counterparties’ decisions to make an election under Regulation 23.701, IECA stated that because “the right to require segregation is so rarely exercised, any response to this question would at best be anecdotal.”⁷⁷

E. Regulation 23.704 – Requirements for non-segregated margin

As proposed, the Commission is amending Regulation 23.704 by placing on the SD or MSP as an entity the obligation to report on a quarterly basis to counterparties that

⁷⁴ *Id.*

⁷⁵ ISDA/SIFMA at 3.

⁷⁶ IFCS at 3.

⁷⁷ IECA at 9 [footnote omitted].

do not elect to require segregation of initial margin (instead of obligating the firm's CCO specifically). A further amendment to paragraph (b) of Regulation 23.704 eliminates the phrase "with respect to each counterparty." Existing Regulation 23.704(a) requires the CCO of each SD or MSP to report quarterly to each counterparty that does not elect segregation of initial margin on whether or not the SD's or MSP's back office procedures relating to margin and collateral requirements failed at any time during the previous calendar quarter to comply with the agreement of the counterparties.⁷⁸ As discussed below, after review of the comments, the Commission confirms the rationale articulated for proposing the amendments to Regulation 23.704, and therefore, is adopting the amendments as proposed.

In the preamble to the Proposal, the Commission expressed its belief that it is unnecessary to specify that the CCO be the individual that makes such reports, so long as the information is provided to counterparties. For many firms, middle or back office staff, not the CCO, implements collateral management pursuant to the terms of each collateral management agreement. Those individuals are therefore better situated to assess compliance with agreements and to provide the quarterly report.⁷⁹ Accordingly, there are likely personnel at each SD or MSP other than the CCO who are better situated to more accurately and efficiently provide the report.⁸⁰ The Commission therefore

⁷⁸ Consistent with CFTC Staff Letter 14-132, *supra* n.8, the Commission confirms that the reporting requirement under Regulation 23.704 does not apply if no initial margin will be required as part of the swap transaction.

⁷⁹ Any potential conflicts of interest on the part of such individuals are mitigated by the oversight function of the CCO with respect to the firm's overall regulatory compliance.

⁸⁰ The Commission notes that the CCO continues to be responsible, under Regulation 3.3, to report in the CCO annual report any material non-compliance issues involving back office procedure relating to margin and collateral requirements.

proposed to require that the SD or MSP make the reports without specifying any particular person to perform that function. The Commission further proposed to clarify the language regarding timing of the required reports to eliminate uncertainty as to the regulation's meaning. With respect to paragraph (b) of the regulation, the Commission proposed to specify that the reports required under paragraph (a) need be delivered only to counterparties who choose not to require segregation (by removing the phrase "with respect to *each* counterparty") consistent with the statutory authority underlying this requirement.⁸¹

IFCS generally supported the changes to Regulation 23.704 while urging the Commission to continue to evaluate the regulation.⁸² NFA and IFCS stated their support for eliminating the requirement that an SD's or MSP's CCO be the individual to issue the quarterly report regarding back office compliance. NFA noted that eliminating the requirement will provide greater flexibility,⁸³ and IFCS stated that eliminating the requirement does not lessen the burden but only shifts it to another corporate department.⁸⁴

IFCS and ISDA/SIFMA stated that the quarterly report does not provide the customer protection benefits the Commission intended to achieve, and urged that instead of requiring quarterly reporting, the Commission should require an SD or MSP to report only when issues of non-compliance are present.⁸⁵ NFA asked the Commission to clarify

⁸¹ See 83 FR at 36489.

⁸² IFCS at 3.

⁸³ NFA at 2.

⁸⁴ IFCS at 3-4.

⁸⁵ IFCS at 3-4; ISDA/SIFMA at 4.

the language of proposed Regulation 23.704(a) to indicate whether a quarterly report is required in those instances when an SD or MSP is and is not in compliance with an agreement with a counterparty.⁸⁶ The Commission notes that the statute specifically requires an SD or MSP to report quarterly to any counterparty that does not elect segregation of initial margin for uncleared swaps “that the back office procedures of the [SD or MSP] relating to margin and collateral requirements are in compliance with the agreement of the counterparties.”⁸⁷ Accordingly, an SD or MSP is required to ensure that its back office procedures are in compliance with the agreement with the counterparty and to report that fact on a quarterly basis, whether or not such procedures are properly carried out on an ongoing basis.

III. Related Matters

A. Regulatory Flexibility Act

The Regulatory Flexibility Act (“RFA”) requires Federal agencies to consider whether the regulations they propose will have a significant economic impact on a substantial number of small entities and, if so, provide a regulatory flexibility analysis respecting the impact.⁸⁸ Whenever an agency publishes a general notice of proposed rulemaking for any regulation, pursuant to the notice-and-comment provisions of the Administrative Procedure Act,⁸⁹ a regulatory flexibility analysis or certification typically is required.⁹⁰ The Commission previously has established certain definitions of “small

⁸⁶ NFA at 3.

⁸⁷ 7 U.S.C. 6s(l)(4).

⁸⁸ 5 U.S.C. 601 *et seq.*

⁸⁹ 5 U.S.C. 553. The Administrative Procedure Act is found at 5 U.S.C. 500 *et seq.*

⁹⁰ *See* 5 U.S.C. 601(2), 603, 604, and 605.

entities” to be used in evaluating the impact of its regulations on small entities in accordance with the RFA.⁹¹ The Commission has previously established that SDs, and MSPs, and eligible contract participants⁹² are not small entities for purposes of the RFA.⁹³

Accordingly, the Chairman, on behalf of the Commission, hereby certifies pursuant to 5 U.S.C. 605(b) that the Proposal will not have a significant economic impact on a substantial number of small entities.

B. Paperwork Reduction Act

1. Background

The Paperwork Reduction Act of 1995 (“PRA”)⁹⁴ imposes certain requirements on Federal agencies (including the Commission) in connection with their conducting or sponsoring a collection of information as defined by the PRA. The rule amendments adopted today would result in such a collection, as discussed below. A person is not required to respond to a collection of information unless it displays a currently valid control number issued by the Office of Management and Budget (“OMB”). The rule amendments include a collection of information for which the Commission has previously received a control number from OMB. The title for this collection of information is “Disclosure and Retention of Certain Information Relating to Swaps

⁹¹ See Registration of Swap Dealers and Major Swap Participants, 77 FR 2613 (Jan. 19, 2012).

⁹² Eligible contract participants, as defined in CEA section 1a(18), 7 U.S.C. 1a(18).

⁹³ See Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant” and “Eligible Contract Participant,” 77 FR 30596, 30701 (May 23, 2012).

⁹⁴ 44 U.S.C. 3501 *et seq.*

Customer Collateral, OMB control number 3038-0075.”⁹⁵ Collection 3038-0075 is currently in force with its control number having been provided by OMB.

The Commission is revising collection 3038-0075 to incorporate changes to reduce the number of notices an SD or MSP must provide to its counterparties with respect to the rights of such counterparties to segregate initial margin for uncleared swaps. The Commission does not believe the rule amendments as adopted impose any other new collections of information that require approval of OMB under the PRA.

2. Modification of Collection 3038-0075

The rule amendments adopted today modify collection 3038-0075 by eliminating the requirement that the notification of the right to segregate be provided on an annual basis to a specified officer of the counterparty such that the notice would only need to be provided once to each counterparty at the beginning of the first non-cleared swap transaction that provides for the exchange of initial margin. The Commission originally estimated that each SD and MSP would, on average, provide the segregation notice to approximately 1,300 counterparties each year and that the burden for preparing and furnishing the notice would be 2 hours, for an annual burden of 2,600 hours.⁹⁶ The Commission now estimates that each SD and MSP will, on average, have approximately 300 new counterparties each year for a total burden of 600 hours per registrant. The Commission received no comments regarding its discussion of the PRA burden analysis in the preamble to the Proposal. Accordingly, the Commission is revising its overall burden estimate associated with Regulation 23.701 for this collection by reducing the per

⁹⁵ See OMB Control No. 3038-0075, <https://www.reginfo.gov/public/do/PRAOMBHistory?ombControlNumber=3038-0075#>.

⁹⁶ See 78 FR at 66631.

registrant annual burden by 2,000 hours. The Commission further estimates that there are 103 SD/MSPs and that the aggregate total burden hours associated with Regulation 23.701 is 61,800. The Commission continues to estimate that Regulation 23.704 would require a total of approximately 2,600 disclosures and 798 hours per year per entity. However, the Commission is adjusting its estimate of the total annual responses and burden hours to reflect an increase by one of the number of respondents. The Commission now estimates that approximately 267,800 total annual responses (which is based on 103 SD/MSPs and the 2,600 disclosures per year per entity) would require total annual burden hours of 82,194.⁹⁷

C. Cost-Benefit Considerations

1. Background

Section 15(a) of the CEA requires the Commission to consider the costs and benefits of its actions before promulgating a regulation under the CEA or issuing certain orders.⁹⁸ CEA section 15(a) further specifies that the costs and benefits shall be evaluated in light of five broad areas of market and public concern: (1) protection of market participants and the public; (2) efficiency, competitiveness, and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. With respect to the rule amendments discussed above, the Commission has considered the costs and benefits resulting from its discretionary determinations with respect to the CEA section 15(a) factors, and sought

⁹⁷ The change in the estimated total annual burden hours for Regulation 23.704 from the original estimate reflects both a change in the total number of registrants and a slight correction to the calculation to correct for arithmetical errors.

⁹⁸ 7 U.S.C. 19(a).

comments from interested persons regarding the nature and extent of such costs and benefits.

The Commission notes that this consideration of costs and benefits is based on the understanding that the swap market functions internationally, with many transactions involving U.S. firms occurring across different international jurisdictions, with some SDs, MSPs, and their counterparties organized outside the U.S., and other entities operating both within and outside the U.S., and commonly following substantially similar business practices wherever located. Where the Commission does not specifically refer to matters of location, the discussion below of the costs and benefits of the regulations being adopted refers to their effects on all subject swaps activity, whether by virtue of the activity's physical location in the United States or by virtue of the activity's connection with or effect on U.S. commerce under CEA section 2(i).

2. Regulations 23.700, 23.701, 23.702, and 23.703 – Notification of right to initial margin segregation

The baseline for these cost and benefit considerations is the status quo, which is existing market conditions and practice in response to the requirements of current Regulations 23.700, 23.701, 23.702, and 23.703.⁹⁹ Subpart L: (1) requires SDs or MSPs to notify counterparties of the right to segregate initial margin; (2) establishes certain procedures regarding the notification; and (3) establishes certain requirements for the initial margin segregation arrangements.

⁹⁹ See 78 FR at 66632-36 (discussing the cost-benefit considerations with regard to the segregation regulation). The Commission believes that the changes to Regulation 23.704 do not change the costs or benefits originally determined when that regulation was adopted.

The rule amendments adopted herein are intended to provide a more flexible approach that reduces some regulatory burdens that provide little or no corresponding benefit. The definition of “Margin” is eliminated because it will no longer be needed. The rule amendments would also revise when the segregation notice is required. Additionally, the amendments eliminate the requirements that the SD or MSP: (1) provide the segregation notice to an officer of the counterparty with specific qualifications, and (2) obtain the counterparty’s confirmation of receipt of the segregation notice. Finally, the rule amendments as adopted allow the parties to establish the notice of change of control provisions and the commercial arrangements for investment of segregated collateral by contract instead of imposing specific requirements.

(i) Cost and Benefit Considerations

The general purpose of the adopted rule amendments is to reduce burdens and improve the benefits intended by subpart L. The Commission believes that the amendments would not impose any new requirements on registrants and instead would reduce or make the regulations more flexible, allowing market participants to use standard market practices regarding the implementation of the initial margin segregation requirements. The simplification of the notification requirements will likely reduce the time needed to complete the notification process. The simplification of the notification requirements may also facilitate more resource-efficient development and maintenance of customer relationships by reducing the search costs for some of the removed items. The rule amendments will also reduce costs by eliminating the requirements for those swaps that must comply with the Prudential Regulator Margin Rules mandatory margin requirements. In addition, the amendments as adopted will provide benefits to the parties

to swaps by allowing the parties to establish by contract the terms for collateral management and for change in control and investment of segregated initial margin in a manner that better suits their business needs. To the extent the parties will be able to negotiate more efficient segregation investment arrangements that generate higher returns that are passed on to the counterparty, as is most often the case for uncleared swaps, the parties will benefit. The Commission believes that the simplification of the requirements and greater flexibility will therefore encourage more counterparties to elect to segregate initial margin.

As noted above, in some circumstances, nonfinancial end-user counterparties might have less negotiating leverage when negotiating the terms of segregation agreements with experienced SDs or MSPs. Reducing the prescriptive requirements in the current rule could therefore reduce protections for the counterparties. However, it is not clear how incentives or disincentives may impact the negotiating choices of SDs and MSPs as well as the counterparties and therefore the extent to which the requirements provide protections. For example, regarding the choice of investments, the SD or MSP may seek to restrict investments to the most liquid investments that could be easily liquidated if the counterparty defaults. Those liquid investments, which would likely be similar to the investments permitted under Regulation 1.25, may in turn generate lower returns passed on to the SD's or MSP's counterparties. Conversely, the current regulations give little or no flexibility for counterparties and SDs or MSPs to negotiate mutually beneficial terms and consider other factors such as the broader financial relationship between the parties. Furthermore, for nonfinancial end-user counterparties, the segregation of initial margin is discretionary. If the counterparties have no voice in

how segregated initial margin is invested, there may be less incentive for the counterparty to elect to require segregation. In addition, because the counterparty will no longer receive an annual notice of its right to segregation, this may result in a counterparty not exercising its right, as a result of new or other employees taking over this responsibility; however, as noted above, once a counterparty selects an option, it rarely changes. Lastly, there is less information given to the counterparty (i.e., custodial prices, including a non-affiliated custodian); however, as noted above, this information is typically not comparable and therefore, may be misleading, as each custodial agreement is privately negotiated.

The Commission believes that the rule amendments to subpart L might lead to reduced costs for registrants, because they will no longer have to comply with some of the more prescriptive requirements imposed by the regulations. The Commission is, however, unable to quantify the potential cost savings because the cost savings depend on numerous factors that are particular to each SD or MSP and each counterparty relationship. For example, the factors affecting the costs involved could include: the size and complexity of an SD's dealing activities, the actual number of swaps that would be affected by this rulemaking, the complexity of the swap transactions, the level of sophistication of each counterparty, the degree to which automated notice technologies may be used to satisfy these requirements, and the nature of the custodial and investment documents in particular segregation arrangements.

(ii) Section 15(a) Considerations

a. Protection of Market Participants and the Public

Subpart L is intended to provide counterparties to SDs and MSPs with notice of the right to elect to segregate initial margin. The Commission recognizes that the amendments adopted to make the regulations less prescriptive might potentially negatively impact the goal of protecting market participants by removing specific requirements for the segregation agreements. However, the Commission is of the view that the intended purpose and benefits of subpart L remain in place because the rule amendments as adopted continue to implement the statutory requirements. Each counterparty will still receive notification of its right to segregate its initial margin. In addition, the parties and the selected custodian will now have the flexibility to establish requirements for margin segregation through negotiated contracts that meet their respective needs, thereby providing market participants with the flexibility and opportunity to protect themselves better by contract. Finally, the greater flexibility provided by these amendments may increase the voluntary use of initial margin segregation by counterparties, a process that was intended to provide better protection for the counterparty in the event of default by the SD or MSP.

The Commission acknowledges that by eliminating the requirement to reinvest initial margin in Regulation 1.25 liquid securities, it may be lowering protections to SDs or MSPs and their counterparties, which may affect other market participants and the public. The Commission believes that this change provides market participants with the ability to privately negotiate the terms of reinvestment. The private terms of reinvestment allow each party to assess its risk tolerance and enter into a written

agreement that reflects this tolerance and possibly earn higher anticipated returns on excess margin than potential returns from Regulation 1.25 liquid securities investments.

b. Efficiency, Competitiveness, and Financial Integrity of Markets

Subpart L promotes the financial integrity of markets by providing for the protection of counterparty collateral and by mitigating systemic risk that may result from the loss of access to the collateral in the event of a counterparty default. As discussed above, given that registrants will still be expected to enter into segregation arrangements with counterparties that elect to segregate, and, with adoption of the rule amendments to subpart L, registrants will now be able to develop segregation arrangements tailored to their businesses and swap transactions, the Commission is of the view that the amendments likely will have a positive impact on market integrity.

The Commission believes that the rule amendments will not have a significant impact on the competitiveness or efficiency of markets because this rulemaking affects only how collateral is protected and segregated, and not how market participants elect to trade. In addition, the Commission believes that not requiring SDs or MSPs to provide custodial pricing information to their counterparties may have an impact on the efficiency, competitiveness, and financial integrity of the markets, as discussed above, although the effect of this information might not have a consequential impact on the decisions of swap counterparties.

c. Price Discovery

The Commission believes the rule amendments as adopted will not have a significant effect on price discovery.

d. Sound Risk Management

Subpart L provides for the management and protection of counterparty collateral and therefore mitigates the risk of loss of access to the collateral, which loss can have an adverse impact on registrants, counterparties and the U.S. financial markets. As discussed, the rule amendments adopted herein remove certain prescriptive requirements, but do not alter the overall principles of the existing requirements of subpart L. Therefore, the Commission is of the view that sound risk management practices will not be adversely impacted by these rule amendments. However, as noted above, the Commission acknowledges that by eliminating the requirement to reinvest initial margin in Regulation 1.25 liquid securities, the rule may be lowering protections to SDs or MSPs and their counterparties, which affects other market participants and the public. On the other hand, the Commission believes that the rule provides market participants with the ability to privately negotiate the terms of reinvestment, thereby allowing each party to assess its risk tolerance and enter into an agreement that reflects this tolerance and to earn higher anticipated returns on excess margin than Regulation 1.25 liquid securities tend to earn.

e. Other Public Interest Considerations

The Commission has not identified any other public interest considerations for the rule amendments as adopted.

(iii) Request for Comment

The Commission invited comment on its preliminary consideration of the costs and benefits associated with the proposed changes to subpart L, especially with respect to the five factors the Commission is required to consider under CEA section 15(a). In

addressing these areas and any other aspect of the Commission’s preliminary cost-benefit considerations, the Commission encouraged commenters to submit any data or other information they may have quantifying and/or qualifying the costs and benefits of the proposal. The Commission also specifically requested comment on the following questions:

- To what extent do the proposed amendments reduce or increase burdens and costs for SDs or MSPs or their counterparties?

Commenters have supported the Commission’s assessment that finalizing the rule amendments will eliminate burdens on SDs and MSPs. Specifically, IECA stated that the current rules have been unnecessarily burdensome and asserted that by eliminating, for example, Regulation 23.701(d), market participants will save significant costs and avoid risk and confusion.¹⁰⁰ IFCS stated its belief that many of the requirements under the current regulations create unnecessary operational and administrative burdens on swap dealers that outweigh the intended protections afforded to swap counterparties.¹⁰¹ ISDA/SIFMA stated that the Proposal will meaningfully reduce unnecessary costs and burdens associated with the rule, without diminishing the Commission’s ability to meet its regulatory duties. ISDA/SIFMA added that, based on their members’ experience, the current initial margin segregation requirements are overly prescriptive and remove the opportunity for bilateral negotiations between sophisticated market participants.¹⁰²

¹⁰⁰ IECA at 2.

¹⁰¹ IFCS at 2.

¹⁰² ISDA/SIFMA at 3.

- To what extent do the proposed amendments impact collateral management risk considerations?

The Commission is persuaded further by commenters that it is appropriate to make its rules less prescriptive and allow more bilateral negotiations between swap counterparties. NFA stated that it agrees with the Commission's goal of reducing unnecessary burdens on market participants, facilitating more efficient swap execution and potentially encouraging more segregation of collateral.¹⁰³ ISDA/SIFMA stated that, based on their members' experience, the current initial margin segregation requirements are overly prescriptive and remove the opportunity for bilateral negotiations between sophisticated market participants who should be allowed to determine what collateral arrangements are most appropriate for their circumstances.¹⁰⁴

- Are counterparties to SDs or MSPs at a substantial disadvantage when negotiating the terms for segregation arrangements that would no longer be required if the proposed amendments are adopted? Would that disadvantage cause them to receive unfair terms on those segregation arrangements? Are there mitigating factors?

The Commission is sympathetic to comments that swap counterparties do not require any additional protections from the CFTC given their requisite levels of sophistication. IFCS stated its support for increased flexibility on the requirements for segregated margin in Regulation 23.702. IFCS believes the current regulations are overly prescriptive and welcomes the opportunity for bilateral negotiations between

¹⁰³ NFA at 1.

¹⁰⁴ ISDA/SIFMA at 3.

sophisticated market participants who are, by definition, deemed to be able to protect their own interests.¹⁰⁵

- Would the elimination of the requirement to list at least one non-affiliated custodian and the cost of the custodial services have an effect on the selection of an independent custodian and the cost of the services to the non-SD/MSP counterparty? If yes, please explain.

The only commenter to address this issue, IFCS, agrees with the Commission's decision to remove this condition. IFCS said that they supported eliminating the requirement, adding that costs associated with segregation are largely controlled by the third-party custodian and may vary for each segregation agreement, which, together, make it difficult to provide meaningful pricing information in the notification.¹⁰⁶

D. Antitrust Considerations

Section 15(b) of the CEA requires the Commission to “take into consideration the public interest to be protected by the antitrust laws and endeavor to take the least anticompetitive means of achieving the purposes of this Act, in issuing any order or adopting any Commission rule or regulation (including any exemption under section 4(c) or 4c(b)), or in requiring or approving any bylaw, rule, or regulation of a contract market or registered futures association established pursuant to section 17 of the Act.”¹⁰⁷

The Commission believes that the public interest to be protected by the antitrust laws is generally to protect competition. The Commission requested comment on

¹⁰⁵ IFCS at 3.

¹⁰⁶ IFCS at 2.

¹⁰⁷ See 7 U.S.C. 19(b).

whether the proposed rule implicates any other specific public interest to be protected by the antitrust laws. No comments were received in response to this request.

The Commission has considered whether the adopted rule amendments are anticompetitive and has identified no anticompetitive effects. The Commission requested comment on whether the proposed rule is anticompetitive and, if it is, what the anticompetitive effects are. No comments were received in response to this request.

Because the Commission has determined that the proposed rule is not anticompetitive and has no anticompetitive effects, the Commission has not identified any less anticompetitive means of achieving the purposes of the Act. The Commission requested comment on whether there are less anticompetitive means of achieving the relevant purposes of the Act that would otherwise be served by adopting the proposed rule. No comments were received in response to this request.

List of Subjects in 17 CFR Part 23

Custodians, Major swap participants, Margin, Segregation, Swap dealers, Swaps, Uncleared swaps

For the reasons stated in the preamble, the Commodity Futures Trading Commission amends 17 CFR part 23 as follows:

PART 23 – SWAP DEALERS AND MAJOR SWAP PARTICIPANTS

1. The authority citation for part 23 continues to read as follows:

Authority: 7 U.S.C. 1a, 2, 6, 6a, 6b, 6b-1, 6c, 6p, 6r, 6s, 6t, 9, 9a, 12, 12a, 13b, 13c, 16a, 18, 19, 21.

Section 23.160 also issued under 7 U.S.C. 2(i); Sec.721(b), Pub. L. 111-203, 124 Stat.1641 (2010).

2. Revise subpart L to read as follows:

Subpart L – Segregation of Assets Held as Collateral in Uncleared Swap

Transactions

Sec.

23.700 Definitions.

23.701 Notification of right to segregation.

23.702 Requirements for segregated initial margin.

23.703 Investment of segregated initial margin.

23.704 Requirements for non-segregated margin.

Subpart L – Segregation of Assets Held as Collateral in Uncleared Swap

Transactions

§ 23.700 Definitions.

As used in this subpart:

Initial Margin means 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.

Segregate means to keep two or more items in separate accounts, and to avoid combining them in the same transfer between two accounts.

Variation Margin means a payment made by or collateral posted by a party to a swap to cover the current exposure arising from changes in the market value of the position since the trade was executed or the previous time the position was marked to market.

§ 23.701 Notification of right to segregation.

(a) At the beginning of the first swap transaction that provides for the exchange of Initial Margin, a swap dealer or major swap participant must notify the counterparty that the counterparty has the right to require that any Initial Margin the counterparty provides

in connection with such transaction be segregated in accordance with §§ 23.702 and 23.703, except in those circumstances where segregation is mandatory pursuant to § 23.157 or rules adopted by the prudential regulators pursuant to section 4s(e)(2)(A) of the Act.

(b) The right referred to in paragraph (a) of this section does not extend to Variation Margin.

(c) If the counterparty elects to segregate Initial Margin, the terms of segregation shall be established by written agreement.

(d) A counterparty's election, if applicable, to require segregation of Initial Margin or not to require such segregation, may be changed at the discretion of the counterparty upon written notice delivered to the swap dealer or major swap participant, which changed election shall be applicable to all swaps entered into between the parties after such delivery.

§ 23.702 Requirements for segregated initial margin.

(a) The custodian of Initial Margin, segregated pursuant to an election under § 23.701, must be a legal entity independent of both the swap dealer or major swap participant and the counterparty.

(b) Initial Margin that is segregated pursuant to an election under § 23.701 must be held in an account segregated for, and on behalf of, the counterparty, and designated as such. Such an account may, if the swap dealer or major swap participant and the counterparty agree, also hold Variation Margin.

(c) Any agreement for the segregation of Initial Margin pursuant to this section shall be in writing, shall include the custodian as a party, and shall provide that any

instruction to withdraw Initial Margin shall be in writing and that notification of the withdrawal shall be given immediately to the non-withdrawing party.

§ 23.703 Investment of segregated initial margin.

The swap dealer or major swap participant and the counterparty may enter into any commercial arrangement, in writing, regarding the investment of Initial Margin segregated pursuant to § 23.701 and the related allocation of gains and losses resulting from such investment.

§ 23.704 Requirements for non-segregated margin.

(a) Each swap dealer or major swap participant shall report to each counterparty that does not choose to require segregation of Initial Margin pursuant to § 23.701(a), on a quarterly basis, no later than the fifteenth business day after the end of the quarter, that the back office procedures of the swap dealer or major swap participant relating to margin and collateral requirements are in compliance with the agreement of the counterparties.

(b) The obligation specified in paragraph (a) of this section shall apply no earlier than the 90th calendar day after the date on which the first swap is transacted between the counterparty and the swap dealer or major swap participant.

Issued in Washington, DC, on March 28, 2019, by the Commission.

Christopher Kirkpatrick,
Secretary of the Commission.

NOTE: The following appendices will not appear in the Code of Federal Regulations.

Appendices to Segregation of Assets Held as Collateral in Uncleared Swap Transactions – Commission Voting Summary, Chairman’s Statement, and Commissioners’ Statements

Appendix 1 – Commission Voting Summary

On this matter, Chairman Giancarlo and Commissioners Quintenz, Behnam, Stump, and Berkovitz voted in the affirmative. No Commissioner voted in the negative.

Appendix 2 – Statement of Chairman J. Christopher Giancarlo

This final rule is another Project KISS proposal simplifying and reducing burdens by revisiting our rules based on staff implementation experience and public comment. Today’s amendments will remove overly burdensome and prescriptive conditions for providing notice to counterparties of their right to segregate initial margin for uncleared swaps and the commercial arrangement between the parties regarding the investment of segregated initial margin.

Staff experience shows that counterparties rarely elect to segregate initial margin, even though the option to do so was provided for in the Commodity Exchange Act and in the CFTC’s Regulations 23.700 through 23.704. Enabling the election of segregation is a bipartisan goal, starting with a unanimous Commission rulemaking by a previous commission. By reducing the burdens and prescriptiveness of these rules, and providing additional flexibility for the parties to engage in written segregation arrangements to fit their needs, as the final rule does here, more counterparties may opt to use this provision and avail themselves of any benefits of doing so.

Appendix 3 – Concurring Statement of Commissioner Rostin Behnam

I respectfully concur with the Commodity Futures Trading Commission’s (the “Commission” or “CFTC”) approval of amendments to subpart L of the Commission’s Regulations (“Segregation of Assets Held as Collateral in Uncleared Swap Transactions” consisting of Regulations 23.700 through 23.704), which implement section 4s(*l*) of the Commodity Exchange Act (“CEA” or the “Act”). The amendments to subpart L respond to ongoing concerns and confusion created by the finalization of the CFTC and Prudential Regulator Margin Rules and CFTC interpretive guidance. I voted for the proposal of the subpart L amendments. However, I expressed reservations about the Commission’s proposal to extend its prior interpretation of CEA section 4s(*l*) concerning the timing and frequency of required notifications of swap counterparties regarding their right to segregate initial margin for uncleared swaps.¹ I continue to believe that the Commission’s rationale in support of interpreting CEA section 4s(*l*) to require a single, one-time notification to a counterparty of their right to require segregation of any initial margin may be based on an incomplete record; it is nevertheless based on the record before us. The Commission sought comment from the public on the appropriateness of the proposed amendments and received just four comment letters. However, none of the letters addressed whether and how requiring the notice to be provided annually has actually impacted or effected decision making by counterparties.

I am disappointed that the Commission is declining to specify what constitutes the beginning of the first swap transaction or to proscribe when trading may commence

¹ Segregation of Assets Held as Collateral in Uncleared Swap Transactions, 83 FR 36484, 36493 through 36494 (proposed July 30, 2018).

following the initial notification.² In an effort to remain flexible, the Commission is creating uncertainty that may ultimately lead to additional rulemaking. Where the record suggests that need for the current amendment to the notification requirement in CFTC Regulation 23.701(a)(i) may be a consequence of a stakeholder-led compliance effort, I believe the Commission ought not to risk making the same mistake twice.

Appendix 4 – Statement of Commissioner Dan M. Berkovitz

The final rule amends CFTC regulations giving certain swap counterparties the right to require initial margin segregation. I support the amendments.

In this instance, real world experience in implementing new regulations demonstrates that modifying certain of the regulatory requirements may help better achieve the intended customer protection goals. An added benefit of fine-tuning the regulations is a reduction in costs for registrants without a reduction in customer protections.

CFTC regulations 23.701 through 23.704 (“Margin Segregation Rules”) set forth certain requirements concerning the right of counterparties of swap dealers to elect segregation of initial margin posted to secure uncleared swaps. These regulations support an important safety measure for mostly non-financial swap counterparties by providing them the right to have collateral posted as initial margin for swaps to be held in segregated accounts at third-party custodians. Segregation protects the counterparty by keeping the counterparty’s collateral, and the collateral posted by the swap dealer to cover obligations to the counterparty, separate from the swap dealer’s other assets and

² Segregation of Assets Held as Collateral in Uncleared Swap Transactions, section II.B. (to be codified at 17 CFR part 23).

liabilities in the event of a bankruptcy. The regulations currently in effect provide detailed requirements regarding the delivery of notices by swap dealers to their counterparties of the right to segregate as well as specific, limited investment choices for the collateral.

The Margin Segregation Rules were adopted in 2013. Since that time, two things have happened to warrant changes to the regulations. First, in 2016, the Commission adopted its uncleared swaps margin regulations. The margin rules effectively superseded regulations 23.702 and 23.703 regarding investment of margin funds for a large majority of affected swap counterparties. Second, as detailed in the final release, experience from implementing the Margin Segregation Rules demonstrated that certain aspects of these rules have provided little or no benefit. Almost no counterparties are electing to segregate initial margin in the manner provided by the Margin Segregation Rules with fewer than five counterparties making the election at each of the swap dealers examined for this issue. In addition, some of the specific requirements of the rule added unnecessary costs and the rule's purpose could be achieved through more efficient means.

The amendments in the final rule will reduce the burdens of the rule's notice requirements while assuring that each counterparty is properly notified of the important right to segregate initial margin at the most effective time in the swap documentation process. The final rule also provides the parties with greater flexibility to negotiate mutually beneficial terms for the segregation arrangements based on the specific needs of the counterparties. This flexibility may encourage more counterparties to elect segregation. In addition, the final rule will increase regulatory efficiency by reducing

unnecessary notices and procedural requirements that must be documented and examined by the National Futures Association in their oversight of swap dealers.

The reduced costs and greater flexibility that will result from the final rule should benefit both swap dealers and end users in uncleared swap transactions. The comment letters that the Commission received on the notice of proposed rulemaking all provided reasoned support for the proposal. I therefore support today's final rule.

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