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CFTC Deadlines Approach for Swap Dealer Margin Segregation Notifications and Buy-Side Responses

Market participants that enter into uncleared swaps should expect to receive notifications from swap dealer (SD) and major swap participant (MSP) counterparties regarding segregation of initial margin for swaps. Dodd-Frank amended Commodity Exchange Act Section 4s(l) to provide SD and MSP counterparties with the right to have any initial margin posted in connection with an uncleared swap to be held by an independent custodian. Recently adopted Commodity Futures Trading Commission (CFTC) rules require SDs and MSPs to notify counterparties of their right to segregate initial margin, to obtain confirmation of receipt of the notice, and to obtain the counterparty's election of whether to segregate initial margin (Segregation Notification Rules).¹ Market participants that do not respond to these notices risk that their SD and MSP counterparties will cease trading with them.

Although many market participants currently do not post initial margin or an independent amount at the outset of entering into uncleared swaps, the Segregation Notification Rules require that SDs and MSPs obtain an election from each counterparty. Moreover, the CFTC currently does not require either counterparty to an uncleared swap to post margin, although it and other regulators have proposed uncleared margin rules.² However, not posting initial uncleared margin (either because CFTC rules do not so require or the parties did not so agree) does not obviate the need to respond to notifications from SD and MSP counterparties of the right to segregate this margin.

The CFTC's Segregation Notification Rules

The Segregation Notification Rules require that before an SD or MSP can confirm the terms of an uncleared swap transaction with a buy-side counterparty, it must:

1. notify the counterparty of the right to segregate initial margin for uncleared swaps; and
2. receive confirmation from the counterparty that its officer "responsible for management of collateral" has received the notification and made an election whether to segregate.³

¹ See Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy, 78 Fed. Reg. 66621 (Nov. 6, 2013). For additional information on the rulemaking, please refer to a prior Skadden client alert, available at: https://www.skadden.com/sites/default/files/publications/CFTC_Expands_Large_Trader_Reporting_and_Increases_Customer_Account_Protection_Requirements.pdf. The right to segregate margin only applies to initial margin (such as the "independent amount" in ISDA credit support annexes) and does not extend to variation margin, which typically is collected on a mark-to-market basis throughout the life of the swap.

² The CFTC, the Securities and Exchange Commission (SEC), and the prudential banking regulators each have proposed uncleared margin rules. See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 23732 (proposed April 28, 2011) (CFTC); Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, 76 Fed. Reg. 70,213 (proposed Nov. 23, 2012) (SEC); Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. 27,564 (proposed May 11, 2011) (banking regulators).

³ See 17 C.F.R. § 23.701. The Segregation Notification Rules must be satisfied at least once annually for each counterparty with which the SD or MSP will trade uncleared swaps.

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The Segregation Notification Rules became effective on January 6, 2014. SDs and MSPs that on-board “new counterparties” (*e.g.*, execute an ISDA Master Agreements with a counterparty) on or after this date have until May 5, 2014, to comply with the Segregation Notification Rules; for “existing counterparties” (*e.g.*, those which have ISDA trading relationships that existed prior to the effective date), SDs and MSPs have until November 3, 2014, to comply. Entities that are subject to the earlier May 5 deadline or that do not want to delay responding to their SD and MSP counterparties should keep in mind that the CFTC rules allow a market participant to change its initial uncleared margin segregation election at any time,⁴ (and that there will be a cost to establishing a segregated account).

⁴ See 17 C.F.R. § 23.701(f).