



**Futures Industry Association**

2001 Pennsylvania Ave. NW

Suite 600

Washington, DC 20006-1823

202.466.5460

202.296.3184 fax

[www.futuresindustry.org](http://www.futuresindustry.org)

**By Commission Website**

April 14, 2011

Mr. David A. Stawick  
Secretary  
Commodity Futures Trading Commission  
1155 21<sup>st</sup> Street NW  
Washington DC 20581

**Re: RIN 3038-AC98: Requirements for Processing, Clearing and Transfer of Customer Positions, 76 Fed.Reg. 13101 (March 10, 2011)**

Dear Mr. Stawick:

The Futures Industry Association (“FIA”)<sup>1</sup> is pleased to submit this letter in response to the Commodity Futures Trading Commission’s (“Commission’s”) notice of proposed rulemaking relating to the processing, clearing and transfer of customer swap positions. The proposed rules would: (i) establish time frames for the submission of swap transactions to a derivatives clearing organization (“DCO”); (ii) require designated contract markets (“DCMs”) and swap execution facilities (“SEFs”) to coordinate with DCOs in the development of rules and procedures to facilitate clearing; (iii) set standards for cleared swaps; and (iv) require a DCO, upon a customer’s request, to transfer such customer’s positions and related collateral from one clearing member to another without requiring the close-out and re-booking of positions.

**Executive Summary**

FIA supports the underlying purposes of the proposed rules, *i.e.*, to assure the financial integrity of swaps submitted for clearing and to confirm a customer’s ability to transfer cleared swaps positions from one clearing member to another clearing member willing to accept such positions promptly. However, the proposed rules fail to recognize the essential role that clearing members play in the transmission and submission of executed swaps for clearing or in assuming responsibility to DCOs for the financial obligations arising from such transactions. Swap dealers, major swap participants and other end-users are not all expected to be clearing members; their contractual relationships, and attendant rights and obligations, are with their respective

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<sup>1</sup> FIA is a principal spokesman for the commodity futures and options industry. FIA’s regular membership is comprised of approximately 30 of the largest futures commission merchants (“FCMs”) in the United States. Among FIA’s associate members are representatives from virtually all other segments of the futures industry, both national and international. Reflecting the scope and diversity of its membership, FIA estimates that its members effect more than eighty percent of all customer transactions executed on United States contract markets.

clearing members, not the DCOs at which the transactions are cleared. Similarly, a DCO looks only to such clearing members in assuring the financial integrity of cleared transactions.<sup>2</sup>

We respectfully submit, therefore, that the proposed rules must be revised to recognize the central role that clearing members play in connection with the processing, acceptance and clearing of swaps.

### **Treatment of Customer Funds**

It is particularly important that the proposed rules regarding the transfer of customer positions take into account the critical role that clearing members play in assuring the financial integrity of cleared transactions. The clearing member's responsibility extends to all customers whose accounts the clearing members carry as well as to the DCOs of which they are a member. In the absence of exigent circumstances, failure to vest primary responsibility for the transfer of customer positions in the carrying clearing member is inconsistent with the Commission's goals of promoting the protection of all market participants, the financial integrity of the markets and sound risk management.

**Proposed Rule 39.15(d).** Proposed Rule 39.15(d) would require a DCO to have rules providing that, upon request of a customer, and subject to the consent of the receiving clearing member, the DCO will promptly transfer all or a portion of a customer's portfolio and funds from the carrying clearing member to the receiving clearing member without requiring the close-out and re-booking of the positions prior to the requested transfer. FIA agrees with the Commission that a customer should not be required to close-out and re-book positions as a condition of transferring such positions from one clearing member to another clearing member that is willing to accept such positions. Further, we agree that a clearing member should not unnecessarily interfere with a customer's request to transfer positions. However, we cannot support the proposed rule as written.

As noted, a DCO interacts with its clearing members' customers solely through those clearing members. A DCO will not have the immediate ability to determine which positions carried in a clearing member's omnibus account belong to a particular customer. As a consequence, if a customer wants to transfer all or a portion of its positions, the customer must direct its request to the clearing member carrying those positions. A DCO's rules, therefore, should provide that the

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<sup>2</sup> As the Commission observed in its Brief *Amicus Curiae* filed with the US Supreme Court in *Klein & Co. Futures, Inc. v. Board of Trade of the City of New York, No. 06-1625*: "[C]learing organizations . . . generally have as their direct customers FCMs, not the ultimate 'customers' who entered into the futures contracts and options positions for which the [FCM's] margin funds were posted." (Citations omitted.) "The customers themselves . . . are not in privity of contract either with the clearinghouse or with each other. Rather, the customer's contractual relationship is with the clearing FCM that is ultimately responsible to the clearinghouse for the customer's trades." Brief, p. 6.

The Brief cites with approval the *Report on Lessons Learned from the Failure of Klein & Co. Futures, Inc.*, prepared by the Commission's Division of Trading and Markets (now, the Division of Clearing and Intermediary Oversight), which states: "Each FCM plays an important risk intermediary role in the marketplace. Clearinghouses look to the funds and credit of clearing FCMs for satisfaction of trading obligations rather than to the actual . . . customer." *Report*, p.2.

customer submit its request to transfer its positions to the clearing member carrying the positions, not to the DCO. Although the DCO would oversee a requested transfer, the transfer would take place between the carrying clearing member and the receiving clearing member.

Moreover, the proposed rule does not appear to permit any conditions precedent to a requested transfer being effected. In the Federal Register release explaining this proposed rule, however, the Commission states that such transfer would be “subject to any notice or other contractual requirements.”<sup>3</sup> We recommend that the Commission revise the proposed rule to confirm that a clearing member is required to transfer customer positions only after the customer has met all contractual obligations. Such obligations would include outstanding margin calls and any additional margin that may be required to support any remaining positions. Such additional margin requirements may arise from portfolio margining arrangements or, as described below, because the customer’s riskier positions will be left behind.

Margin is assessed against a customer based on a clearing member’s analysis of the risk presented by the entire portfolio of positions being carried, including both cleared and uncleared positions. If a portion of those positions is transferred, the risk profile of the remaining positions may change (*i.e.*, the transfer of a portion of a portfolio may reduce or remove the offsetting benefits of the transferred positions and, therefore, require a top-up in the margin owing in respect of the futures, swaps or securities positions remaining in the portfolio). In these circumstances, the clearing member should have the right to receive any additional required margin before completing a transfer of positions to another clearing member.

We note, in this regard, that a transferee will be able to determine which risks it is comfortable accepting and which it would reject, particularly in a crisis. In the event of a crisis or specific systemic issue affecting one asset class, it is likely that a transferee will reject specific positions, if it has any concern regarding a ready market for the risk, the inability to determine pricing for variation margin purposes, or other factors. In these circumstances, the remaining positions left with the original clearing member would be impaired.

For example, prior to the financial crisis, generally accepted collateral terms in the market for both ABX Index risk and highly-rated single-name CDS on ABS risk were quite aggressive. As the crisis increased in severity, the market polarized in favor of the liquid index and against any single-name risk, *i.e.*, trading continued on the index, but pricing availability and liquidity were severely impaired in single-name risk. If a customer that had previously constructed a portfolio of ABX against its single-name CDS on ABS constituents, resulting in a relatively low-risk basis position, then requested a partial transfer of its portfolio, to include only the ABX position, the original clearing member would have been put in a hazardous risk position, even if the then-prevailing clearing organization margin was paid on the remaining positions. Certainly, if a customer transfers its entire portfolio (cleared and uncleared positions), no additional payments may be required.

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<sup>3</sup> Id., at 13107

## Swap Processing and Clearing

FIA shares the Commission's desire to assure the financial integrity of swaps intended to be submitted for clearing by facilitating the prompt and efficient processing of such transactions. Cleared swaps reduce bilateral counterparty risk; to the extent that parties have executed a swap in anticipation that it will be cleared, it is in their interests (as well as in the interests of general market stability) to assure that the time between execution of a swap and its acceptance for clearing is minimized. However, the proposed rules do not properly reflect the essential role that clearing members play in the transmission and submission of executed swaps, in particular swaps not executed on a SEF or DCM, to a DCO for clearing.

To the contrary, the proposed rules appear to contemplate no role for clearing members before a trade is submitted for clearing and accepted by the DCO. Swap dealers, major swap participants, SEFs and DCMs are required to coordinate with DCOs, and DCOs with them, but the proposed rules would require no party to coordinate with the clearing members that carry the accounts of swap dealers, major swap participants and other market participants. Clearing members guarantee the obligations of their customers and the proposed rules must recognize the right of a clearing member — and afford the clearing member the opportunity — to make a risk-based decision whether to accept a swap for clearing or reject it for breach of established credit limits or other risk-related reasons.<sup>4</sup>

**Proposed Rule 23.506(a).** FIA agrees with the underlying purpose of proposed Rule 23.506(a). Market participants should have the capacity to route orders that are not executed on a SEF or DCM to a DCO in a manner acceptable to the DCO. However, this obligation is more appropriately imposed on clearing members, not swap dealers or major swap participants. A DCO deals directly only with its clearing members, which are the only entities that maintain accounts at the DCO and with which the DCO is in privity. The parties to a swap, whether swap dealers, swap participants or end users, likely will not be direct clearing members. Rather than requiring swap dealers and major swap participants to have the capacity to route orders to a DCO, therefore, it would be more appropriate to require such entities to assure that they have clearing arrangements in place with clearing members that, in turn, have the capacity to route orders to a DCO in a manner acceptable to it.

**Proposed Rule 23.506(b).** We are concerned with the provisions of proposed Rule 23.506(b)(1), which would require a swap dealer or major swap participant to submit a swap for clearing “to a derivatives clearing organization as soon as technologically practicable after execution” but in any event “no later than the close of business on the day of execution.” As described above, swap dealers and major swap participants are unlikely to submit a swap directly to a DCO for clearing. Rather, we anticipate that the parties instead will affirm the relevant terms of the swap by, among other means, submitting the details of the swap transaction to an affirmation platform, prior to submitting it to their respective clearing members for submission to the DCO. With the multitude of models for execution to clearing that are likely to develop in the market, we believe it would be more appropriate to adopt a principles-based rule that simply

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<sup>4</sup> Any such rejection must occur promptly to allow the parties to the trade to adjust their positions timely.

requires swap dealers and major swap participants to act promptly in taking the steps necessary to facilitate the clearing of a swap.

We are also concerned that compliance with the requirement that a swap dealer or major swap participant submit a swap that is subject to mandatory clearing “as soon as technologically practicable after execution of the swap, but no later than the close of business on the day of execution,”<sup>5</sup> may not always be possible. A swap dealer and its customer may enter into a bilateral swap at any time during the day. A DCO’s business day, however, will begin and end on a fixed schedule. Further, DCOs generally establish cut-off times prior to the end of their business day, beyond which time they will not accept a swap for clearing. If the parties do not enter into a swap until late in the day and, therefore, are unable to submit a swap for clearing before such cut-off time, the swap will not be submitted for clearing “on the day of execution.” We recommend that the Commission amend this proposed rule in order to provide the parties greater flexibility to submit a swap for clearing within a reasonable time as prescribed by the applicable DCO.<sup>6</sup>

With respect to swaps that are not subject to mandatory clearing, but which the parties have agreed to clear, the proposed rules provide that a swap dealer or major swap participant must submit the swap for clearing “not later than the next business day after execution of the swap, or the agreement to clear, if later than execution.”<sup>7</sup> The proposed rule acknowledges that the parties to a bilateral transaction may need additional time to agree to the terms of a swap and, equally important, may elect to clear a swap at some point well after a swap has been entered into.

However, we believe the rule should also take into account that the parties may elect to submit a number of uncleared swaps for clearing and either may be unable to submit all such swaps by the next business day or may have valid business reasons to submit such swaps on a fixed schedule over a period of time (*e.g.*, where parties have determined to back-load an existing portfolio of swaps). To encourage the voluntary use of clearing where such swaps are not required to be cleared, we suggest that the proposed rule be revised to permit the parties to submit such trades for clearing on any date to which the parties and their respective clearing firms agree.

**Proposed Rules 37.702(b) and 38.601(a).** FIA supports the provisions of proposed Rule 37.702(b) and 38.601(a), which would require SEFs and DCMs, respectively, to have the capacity to route swap transactions executed on their respective platforms to a DCO for clearing in a manner acceptable to the DCO and to coordinate with the DCO to facilitate prompt and

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<sup>5</sup> Proposed Rule 23.506(b)(1).

<sup>6</sup> A useful framework is laid out in the CME-Cleared Over-the-Counter Derivatives Give-up Agreement (available at <http://www.cmegroup.com/trading/cds/files/CME-Cleared-CDS-Give-Up-Agreement.pdf>), which essentially defines “Late-day OTC Transactions” as transactions executed after 3:30 pm and extends the timelines of the various parties to perform their respective obligations to the next morning.

<sup>7</sup> Proposed Rule 23.506(b)(2).

efficient processing of swaps.<sup>8</sup> DCOs would have a reciprocal obligation to coordinate with each SEF and DCM that lists for trading a product that is cleared by the DCO.<sup>9</sup>

In complying with these requirements, each SEF and DCM must assure equal access to all DCOs that wish to clear trades executed through the facilities of the SEF or DCM. Failure to grant such access would be inconsistent with the provisions of section 2(h) of the Commodity Exchange Act, as amended by section 723 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which (i) provide for the non-discriminatory clearing of swaps executed bilaterally or on an unaffiliated SEF or DCM,<sup>10</sup> and (ii) provide that, with respect to a swap that is entered into by a swap dealer or major swap participant, the counterparty shall have the sole right to select the DCO through which the swap is cleared.

### Acceptance and Clearing

**Proposed Rule 39.12.** The obligations of DCOs in connection with the acceptance and clearing of swaps are set out in proposed Rule 39.12(b). Among other requirements, Rule 39.12(b) provides that a DCO: (i) must provide that all swaps with the same terms and conditions as defined by templates established under the DCO's rule, submitted for clearing are economically equivalent and may be offset with each other;<sup>11</sup> (ii) must provide for non-discriminatory clearing of swaps executed bilaterally or on an unaffiliated SEF or DCM;<sup>12</sup> (iii) may not refuse to clear a product where neither party to the original contract, agreement, or transaction is a clearing member;<sup>13</sup> and (iv) must select contract unit sizes and other terms and conditions of swaps that it will clear, which may include contract unit sizes that are smaller than the contract units in which trades submitted for clearing are executed, that maximize liquidity, facilitate transparency in pricing, promote open access and allow for effective risk management.<sup>14</sup> We will address these requirements in turn.

The Commission does not define the term "templates." To the extent it is meant to include the terms and conditions of a swap that a DCO will clear, we request the Commission to confirm that "economically equivalent" swaps must have the same cash flows, identical values and liquidation dates. Other terms and conditions of such templates, for example, events of default, should also be consistent with market practice.

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<sup>8</sup> Such swaps, of course, must otherwise meet the DCO's product eligibility requirements for clearing.

<sup>9</sup> Proposed Rule 39.12(b)(7)(i).

<sup>10</sup> This statutory requirement is also set out in proposed Rule 39.12(b)(3).

<sup>11</sup> Proposed Rule 39.12(b)(2).

<sup>12</sup> Proposed Rule 39.12(b)(3).

<sup>13</sup> Proposed Rule 39.12(b)(4).

<sup>14</sup> Proposed Rule 39.12(b)(5).

We have already noted that we support the requirement for the non-discriminatory treatment of swaps executed bilaterally or on a non-affiliated SEF or DCM. Similarly, we support the requirement that a DCO may not refuse to clear a swap where neither party to the original contract is a clearing member.<sup>15</sup>

We appreciate and agree with the purpose underlying the Commission's proposal that DCO's select contract unit sizes that maximize liquidity, facilitate transparency in pricing, promote open access and allow for effective risk management. Nonetheless, as we previously advised the Commission, FIA cannot support the proposed rule at this time. Swaps trade without a smallest notional size, and their size can be arbitrary. Although swap contracts may evolve in such a way that it would be appropriate for a DCO to establish templates regarding the terms and conditions of standardized swaps eligible for clearing, we do not believe the market is at that point. Such templates are appropriate for exchange-traded futures. However, there are significant differences between swaps and futures, and the Commission should not force futures conventions on swaps. Requiring swaps to fit within artificial, prescribed templates would be disruptive to the market and would not benefit customers.<sup>16</sup>

We also previously commented on the provisions of proposed Rule 39.12(b)(6), regarding novation of swaps accepted for clearing. As we explained, the rule appears to provide that a clearing member would be deemed to be a principal with respect to each swap it clears, even those swaps cleared on behalf of customers. This position conflicts with the FCMs' position that, with respect to customer positions, FCMs are acting as agent, and not as principal, for customers in executing and clearing swaps (and futures) on behalf of customers. FIA, therefore, reiterates its request that the proposed rule be revised to confirm that, in clearing swaps on behalf of customers, a clearing member shall be deemed a guarantor and agent of a cleared swap and not a principal.<sup>17</sup>

Proposed Rule 39.12(b)(7) would also establish time frames within which a DCO would be required to accept a swap for clearing depending on the manner in which it is executed and whether it is subject to mandatory clearing. In this regard, proposed Rule 39.12(b)(7)(ii) provides that a DCO must accept for clearing *immediately upon execution* all swaps that are listed for clearing on the DCO: (i) that are entered into on a SEF or DCM; (ii) for which the

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<sup>15</sup> Although it appears unlikely, concern has been expressed that this provision of the proposed rules could be interpreted to prohibit a clearing member from clearing its proprietary trades. We ask the Commission to confirm that this provision would not intended to prevent a party from clearing its own trades.

<sup>16</sup> Letter from John M. Damgard, President, Futures Industry Association, to David A. Stawick, Secretary to the Commission, dated April 7, 2011. Risk Management Requirements for Derivatives Clearing Organizations. As we stated in that letter, FIA would support a requirement that DCOs study this matter and submit a report to the Commission on the feasibility of establishing templates regarding the terms and conditions of standardized swaps as soon as practicable.

<sup>17</sup> Id.

parties have clearing arrangements in place with clearing members of the DCO; and (iii) for which the executing parties identify the DCO as the intended clearing organization.<sup>18</sup>

Similarly, proposed Rule 39.12(b)(7)(iii) would require a DCO to accept for clearing *upon submission to the DCO* all swaps that are listed for clearing on the DCO: (i) that are not executed on a SEF or DCM; (ii) that are subject to the mandatory clearing requirement; (iii) that are submitted by the parties within the time frames described above; (iv) for which the parties have clearing arrangements in place with clearing members of the DCO; and (v) for which the executing parties identify the DCO as the intended clearing organization.

Finally, proposed Rule 39.12(b)(7)(iv) would require a DCO to accept for clearing *no later than the close of business on the day of submission* all swaps that are listed for clearing on the DCO: (i) that are not executed on a SEF or DCM; (ii) that are not subject to the mandatory clearing requirement; (iii) that are submitted by the parties within the time frames described above; (iv) for which the parties have clearing arrangements in place with clearing members of the DCO; and (v) for which the executing parties identify the DCO as the intended clearing organization.

FIA does not believe that a DCO should be required to accept for clearing all swaps that meet any of the above requirements. As with exchange-traded futures contracts, a DCO should have the right, prior to accepting a trade, to confirm that the swap meets its product eligibility requirements, credit standards and other non-discriminatory requirements. If a swap fails to meet any of these requirements, the DCO should have the right to reject the swap for clearing.

Proposed Rule 39.12(b)(7)(v) provides that the rules of a DCO must provide that all swaps submitted for clearing “shall include written documentation that memorializes all of the terms of the transaction and legally supersedes any previous agreement.” FIA requests the Commission to clarify the obligations of the parties under this proposed rule. As written, the rule appears to place responsibility on the parties to the swap to submit a written confirmation of the terms of the transaction to the DCO, which, upon acceptance by the DCO, will supersede any prior documents and serve as the confirmation of the trade. In the Federal Register release accompanying the proposed rule, however, the Commission places responsibility on the DCO, explaining that the proposed rule “would require that DCOs accepting a swap for clearing provide the counterparties with a definitive written record of the terms of their agreement, which will serve as a confirmation of the swap.”<sup>19</sup> Further, the proposed rule appears to apply to all swaps submitted for clearing, but the Federal Register release appears to limit the requirement to swaps not executed on a SEF or DCM, noting that swaps executed on a SEF or DCM are confirmed upon execution.<sup>20</sup>

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<sup>18</sup> In the Federal Register release accompanying the proposed rule, the Commission states that the parties would need to specify in advance where trades should be sent for clearing.

<sup>19</sup> 76 Fed.Reg. 13101, 13105-13106 (March 10, 2011).

<sup>20</sup> Id., at 13106.



## Conclusion

FIA appreciates the opportunity to submit these comments on the proposed rules relating to the processing, clearing and transfer of customer positions. If the Commission has any questions concerning the matters discussed in this letter, please contact Barbara Wierzynski, FIA's Executive Vice President and General Counsel.



Sincerely,

John M. Damgard  
President

cc: Honorable Gary Gensler, Chairman  
Honorable Michael Dunn, Commissioner  
Honorable Jill E. Sommers, Commissioner  
Honorable Bart Chilton, Commissioner  
Honorable Scott O'Malia, Commissioner

Division of Clearing and Intermediary Oversight  
Ananda Radhakrishnan, Director  
John Lawton, Deputy Director  
Phyllis Dietz Associate Director

Division of Market Oversight  
Riva Spear Adriance, Associate Director  
Nancy Markowitz, Assistant Deputy Director  
Nadia Zakir  
Mauricio Melara