SDMA SWAPS & DERIVATIVES MARKET ASSOCIATION

June 3rd, 2011

David A. Stawick, Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington DC 20581

Elizabeth Murphy, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: OTC Derivative Market Integrity & Real-time Trade Processing Requirements for Processing, Clearing, and Transfer of Customer Positions 17 CFR Parts 23, 37, 38 and 39, RIN 3038-AC98; Clearing Agency Standards for Operation and Governance 17 CFR Part 240, RIN 3235-AL 13

Dear Mr. Stawick and Ms. Murphy:

The Swaps & Derivatives Market Association ("SDMA") appreciates the opportunity to provide comments to the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") (CFTC and SEC collectively the "Commissions") on the CFTC's Notice of Proposed Rulemaking regarding Parts 23, 37, 38 and 39 of Title 17 of the Code of Federal Regulation ("CFR 17") entitled "Requirements for Processing, Clearing, and Transfer of Customer Positions" and the SEC's Notice of Proposed Rulemaking regarding Part 240 of Title 17 CFR entitled "Clearing Agency Standards for Operation and Governance". This letter supersedes an earlier submission dated April 19th 2011.

The SDMA is a non-profit financial trade group formed in 2010 to support the goals of the Dodd Frank Act. It believes that systematic risk of OTC derivatives can be mitigated through their regulation, the creation of central clearing, and by ensuring open and transparent access to ensure greater competition, lower transaction costs and greater liquidity. The SDMA is comprised of many US and internationally based broker-dealers, investment banks, futures commission merchants and asset managers participating in all segments of the exchange-traded and over-the-counter derivatives and securities markets.

Introduction

Immediate acceptance of OTC swaps trades into clearing is critical to accomplishing the goals of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd Frank Act") to: (1) reduce systemic risk, (2) increase trade integrity and (3) promote market stability.[1] Settlement uncertainty, caused by time delays between the point of *trade execution* and the point of *trade acceptance into clearing*, could destroy confidence in the cleared OTC derivatives markets. As the CFTC has correctly asserted, such a time delay or "trade latency", (which in the bilateral swaps markets can be as long as a week) directly constrains liquidity, financial certainty and increases risk.[2]

The SDMA supports current proposed CFTC rules that seek to strengthen the financial integrity of the cleared swap markets by addressing the aforementioned trade latency issue by imposing certain uniform standards for prompt processing, submission and trade acceptance into clearing. Specifically, the SDMA strongly believes that the Commissions in their entirety adopt proposed CFTC Rule 39.12 (B) (7) that requires that Derivatives Clearing Organizations (DCOs) accept for clearing 1) all eligible swaps trades transacted on Swap Execution Facilities ("SEFs") *immediately upon execution* and; 2) all eligible swaps trades transacted off SEFs *immediately upon trade submission*. Importantly, the SDMA respectfully requests that the Commissions properly clarify Rule 39.12 (B) (7) consistent with their original intent of ensuring market adoption of "perfect Settlement."

Perfect Settlement, DCO and Clearing Member Compliance

The SDMA agrees with CFTC proposal 39.12 (B) (7) that asserts that the issue of time delay be removed from the trade settlement process by mandating that DCOs require their constituent clearing members to comply with the doctrine of "perfect settlement." With perfect settlement, DCOs mitigate trade latency by requiring that their constituent clearing members guarantee all their customer trades at time of execution. It is well established market practice in certain other cleared derivatives markets that the trade is assumed to be accepted into clearing *immediately upon execution*.

[1] Throughout this letter all references to "swaps" refers to both swaps and security-based swaps that are required to be cleared by Sections 723 and 763, respectively, of the Dodd Frank Act.
[2] Page 13101. (*Federal Register*, Volume 76, No. 47, 3/10/11).

That is to say, the trade is both executed and simultaneously accepted into clearing unless the clearing member has given prior notice to the execution venue or SEF to prevent such a trade from occurring. Trade integrity is assured and settlement risk mitigated because the trade counterparty can look to the customer's FCM or clearing member to be made whole if that defaulting customer cannot pay.

Perfect settlement works well in many cleared derivatives markets globally currently. Some of these markets, such as the CME Eurodollar or CBOT Treasury futures markets, are the largest and most liquid in the world. In these high volume markets, clearing members properly protect themselves by strictly and proactively enforcing customer margin and trading parameters. Clearing members routinely restrict customer trading at execution venues where appropriate. As a consequence, trade integrity is achieved as these markets flow smoothly.

It is functionally proper and appropriate that clearing members have the ability to restrict its customer's trading with regard to prudent risk management, but it is likewise well established and appropriate that clearing members bare the burden of guaranteeing their customer's trades for the following reasons. First, clearing members are the entities best positioned in the trade workflow to monitor a market participant's ability to pay for its trade. Because clearing members administer the customer account, they can easily access this information to assess customer margin and spending power in real time.

Second, the clearing broker is the central *nexus* where all trades, executed across multiple SEF's or execution venues, ultimately intersect. The clearing member is best positioned to proactively monitor such trades flowing in from multiple execution venues and thus quantify its risk to the customer in the aggregate at the respective DCO. By contrast, it is functionally impossible for SEFs, DCM's and bilateral trading environments to link with each other to monitor customer activity across the market and thus their only option is to rely upon DCO connectivity to its constituent clearing members for customer margin visibility and spending power.

Third, the clearing member is in the best position to protect itself. If the clearing member believes itself to be exposed to a customer, it can simply notice the customer, its execution broker and SEF community to restrict the customer's trading real time in advance of a problem. Moreover, clearing members are incented to work with SEFs and execution brokers in such matters as ticket "clipsize" and daily trading notional limitations to protect themselves.

Fourth—because the clearing member charges customers for it's services, they can appropriately require higher fees and margin to reflect higher risk candidates.

Finally, the clearing member is optimally positioned to require additional funds or liquidate a customer position in order to cover any breakage amounts or cover any expenses it may have incurred from a customer trade problem.

Through these proactive actions, the clearing member not only protects itself but, by extension, the execution venue, the customer and the market as a whole.

Commission's Intent of Perfect Settlement with Rule 39.12 (B)

That the CFTC reasonably contemplated perfect settlement with Rules 39.12 (B) (6 & 7) is clear. In Rule 39.12 (B) (7) entitled *Time Frame for clearing,* the CFTC states that to facilitate prompt and efficient processing of transactions on SEFs and DCMs, the DCO "*will accept for clearing, immediately upon execution,* all contracts, agreements, and transactions…" (Emphasis added, FR Rule 39.12 (B) (7) (ii)). Likewise for transactions that occur off SEF's and DCM's, the DCO "will *accept for clearing, immediately upon submission*, all contracts, agreements, and transactions…" (Emphasis added, FR Rule 39.12 (B) (7) (ii)).

Under Rule 39.12 (B) (6), the CFTC properly clarifies the meaning of "accept for clearing." Acceptance into clearing does not mean that the DCO merely acknowledges the receipt of the trade in order for the clearing member to ultimately accept or reject the trade after execution, but rather acceptance into clearing means the following according to the CFTC:

(i) "The original swap is extinguished;
(ii) The original swap is replaced by equal and opposite swaps between clearing members and the derivatives clearing organization;
(iii) All terms of the cleared swap must conform to templates established under the derivatives clearing organization; and
(iv) If a swap is cleared by a clearing member on behalf of a customer, all the terms of the swap, as carried in the customers account on the books of the clearing member, must conform to the terms of the cleared swap

established under the derivatives clearing organization's rules." (FR Rule 39.12 (B) (6)).

Under Rule 39.12 (B) (7), the CFTC properly asserts the doctrine of perfect settlement by explicitly stating that trades clear "immediately upon execution." As the rule is written, the CFTC requires that acceptance by the DCO and its clearing member is *automatic* upon execution. Therefore trade "acceptance" is *equal* to trade "execution". Moreover, it logically follows that the *opposite* is also true. That is, the only way to prevent the trade from being accepted into clearing (i.e. trade rejection) is to prevent the trade from being executed in the first place. Logically only cleared trades can exist. Again, this is consistent with the concept of perfect settlement in other successfully cleared derivatives markets. As the CFTC intends, the DCO and its clearing member must notice the execution venue or SEF to prevent the unsafe customer from executing a rejected trade.

Perfect Settlement: Swap Dealers, DCM and Clearing Member Compliance with CFTC & SEC intent

The CFTC rightfully requires that Swap Dealers, SEFs and DCMs also comply with their doctrine of perfect settlement. The SDMA respectfully asks that the Commissions adopt <u>in their entirety</u> proposed CFTC Rules 23.506, (SDs) 37.702 (SEFs) and 38.601 (DCMs) which require that these entities have the operational capacity to route transactions to DCOs in a real time and that these entities coordinate with DCOs in the "development of rules and procedures to facilitate prompt transaction processing in accordance with Section 39.12 (B) (7)." (FR Rule 23.506, FR Rule 37.702, FR Rule 38.601).

Importantly, the SDMA respectfully requests that the Commissions clarify their rule that requires constituent clearing members or FCMs of DCOs comply with the doctrine of perfect settlement as required of the DCO itself. The SDMA supports CFTC Rule 39.12 (3) and requests that the Commissions adopt it with regard to the requirement that clearing members are required "to have adequate operational capacity to meet obligations arising from participation in the derivatives clearing organization…[that] shall include…the ability to process…transactions cleared within required time frames" but, the SDMA requests, *in strict accordance with Section 39.12 (B) (7) and the doctrine of perfect settlement*.

Perfect Settlement: SEF Compliance with CFTC & SEC intent

SEFs and other execution venues should also comply with the Commission's requirement of perfect settlement. The construct of perfect settlement is also consistent with the Commission rules for SEF's. The SDMA requests that the Commissions adopt CFTC Rule 37.6 (B) in it's entirety with regard to *enforceability*. In such a rule, the CFTC appropriately requires that the "confirmation of all the terms of the transaction shall take place at the same time as execution." (FR Rule 37.6 (B)). Thus, the SDMA supports the CFTC rules that require that OTC derivative trades are both confirmed and accepted into clearing at time of execution.

By contrast it is important to note that SEC proposed rules 242.815 "Financial Integrity of Transactions" and 240.17Ad-22(d) (12) "Standards for Clearing Agencies" fail to provide clear standards for real time trade processing. Proposed rule 242.815 merely provides that security-based swap execution facilities will establish rules to ensure the financial integrity of transactions, and proposed rule 240.17Ad-22(d)(12), provides that a clearinghouse may "… require that intraday or real-time finality be provided where necessary to reduce risks".

The SDMA believes that these SEC rules fail to create a clear standard and, therefore, do not provide a workable framework for cleared swaps trade processing and clearing.

The SDMA respectfully recommends the SEC adopt rules equal to CFTC Rule 37.6(b) and CFTC Rule 39.12 (B) (7) which mandates that SEF traded swaps are immediately confirmed and accepted for clearing upon execution consistent with the doctrine of perfect settlement.

Perfect settlement is also consistent with CFTC SEF Core Principle 7—*Financial Integrity of Transactions*.[3] Such a Core Principle requires that the SEF "establish and enforce rules and procedures for ensuring the financial integrity of swaps…including the clearance and settlement of swaps pursuant to Section 2 (h) (1) of the Act." (FR Rule 37.700). Such a requirement is wholly consistent with the notion that trade rejection is optimally minimized through perfect settlement whereby clearing members guarantee customer trades at point of execution. Likewise, under this Core Principle, the SEF should work with DCOs and their constituent clearing members to ensure that communication systems are in place such that DCO clearing members can notice the SEF of a customer's execution restriction.

[3] All references to "CFTC Core Principles" refer to the core principles for swap execution facilities set forth in section 733 of the Dodd Frank Act, which amends the Commodity Exchange Act to include a new section 5h entitled "Swap Execution Facilities".

Importantly, SEFs cannot practically establish and maintain the financial integrity of transactions without the trade certainty that results from perfect settlement.

Indeed, without perfect settlement where trades are accepted in real time, SEFs will find it difficult to comply with other Core Principles that have a real-time component.

Specifically, SEC and CFTC Core Principle 4--*Monitoring of Trading and Trade Processing* require SEFs to conduct real-time monitoring of trading.[4] Clearly, there can be no real-time monitoring of trading, unless trades occur in real-time. Trades do not occur in real-time if there is a delay between execution and clearing.

SEC Core Principle 8--*Timely Publication of Trading Information* and CFTC Core Principle 9 -- *Timely Publication of Trading Information*, require that SEFs report transaction data on timely basis. The current standard for the transmission of transaction data in other markets is real-time. Without mandated immediate acceptance of cleared swaps upon execution there would be a significant delay between the time of trade execution and clearing of swaps that will adversely impact price transparency, and the SEFs' ability to comply with the core principles related to timely publication of trading information.

Perfect settlement of cleared swaps is also essential to the creation of an accurate, comprehensive audit trail, which is fundamental to SEFs' ability to comply with all the core principles that have an audit trial component. These core principles are: (a) SEC Core Principle 3--*Security-Based Swaps not Readily Susceptible to Manipulation* and CFTC Core Principle 3--*Swaps not Readily Susceptible to Manipulation*, (b) SEC and CFTC Core Principle 5 --*Ability to Obtain Information*, (c) CFTC Core Principle 6--*Position Limits or Accountability*; and (d) SEC Core Principle 9--*Recordkeeping and Reporting* and CFTC Core Principle 10 --*Recordkeeping and Reporting*. Without perfect settlement where trades are accepted into clearing immediately at point of execution, the delay between trade execution and clearing will impede the SEFs ability to maintain an accurate audit trail. This will adversely impact the SEFs' ability to analyze audit trail information to monitor position limits and detect susceptibility to market manipulation.

[4] All references to "SEC Core Principles" refer to the core principles for security-based swap execution facilities set forth in section 763 of the Dodd Frank Act, which amends the Securities Exchange of 1934 to include a new section 3D entitled "Security-Based Swap Execution Facilities".

Lastly, SEFs would not be able to comply with SEC and CFTC Core Principle 1 "Compliance with Core Principles", which requires that the SEFs comply with all of the core principles, and SEC and CFTC Core Principle 2 "Compliance with Rules", that requires SEFs to establish and enforce rules that include, without limitation, trading and trade processing.

Perfect Settlement: Trade Allocations or "Bunched" Trades

The SDMA respectfully requests that the Commissions adopt 39.12 (B) and its clarified doctrine of perfect settlement to include "bunched" trades or trades allocated after the point of execution.

As empirically evident from other cleared markets, it is well established that the doctrine of perfect settlement works quite well for trade allocations or "bunched" trades. The CFTC correctly notes that "for futures traded on a DCM, rules and procedures are in place under which bunched orders are accepted for clearing *immediately upon execution*, with allocation to individual customer accounts occurring before the end of the day" (emphasis added, *Federal Register*. p. 13106).

Similar to the futures markets, swaps customers or asset managers that execute on behalf of multiple legal entities at one time in a "bunched" trade can do so via *omnibus* accounts issued by their clearing member.

The process for swaps trade allocation should be similar to that of the futures markets. First, the customer executes the master swaps trade using such an omnibus account. Second, the clearing member and the DCO accept the master trade into clearing at the time of execution. The DCO and its constituent clearing member does this with the knowledge that the customer will later allocate the master trade later in the day, thus meeting it's obligation under Rule 39, 39.12 (B) (7) clarified for the doctrine of perfect settlement. Third, before 7pm the same trading day, the customer notifies it's clearing member directly of the breakout sub accounts into which the master swaps trade is allocated. If there is a residual amount that has not been paid for, the customer and its clearing member have a previously negotiated solution. For example, common solutions from the listed derivatives markets include the customer absorbing the ticket into one of the other functioning accounts or the clearing member extending temporary credit to cover any temporary shortfall.

Perfect settlement works well for all parties involved in the bunched trade workflow. Asset manager customers that routinely trade on behalf of multiple entities continue to enjoy the efficiencies

and transaction savings that a trade of large size can achieve. Operationally they are easier for the customer because they are not forced to do a pre-trade allocation, but instead have considerable time after trade clearing acceptance and execution to complete the allocation process. Because the allocation occurs directly at the clearing member, the execution venue or SEF is no longer necessary in, what is arguably, a secondary post trade process. Likewise, for a transaction that occurs off SEF or DCM, only the allocating party need concern itself with its own allocation.

In conclusion, the SDMA believes that the CFTC has appropriately set the correct standard with Rule 39.12 (B) (7) and it's doctrine of perfect settlement that efficiently removes the latency issue of time delay between point of execution and point of trade acceptance into clearing. It is this latency that, as the CFTC has correctly noticed directly constrains liquidity, financial certainty and increases risk. It is proper and prudent for the Commissions to require that the OTC swaps market comply with the regulators requirement for perfect settlement. As discussed, it works well in other cleared derivatives markets, it provides for smooth workflow with regard for bunched orders and it provides the framework for execution venues such as SEFs to properly meet their obligation with Core Principles for financial integrity, real time reporting, audit and enforcement.

The SDMA respectfully requests that the Commissions adopt such rule sets and clarify (where necessary) to ensure that DCOs and their constituent clearing members conform to such rules by adopting perfect settlement as the standard for the newly cleared OTC swaps markets.

Allowing Time Delay in the Workflow: Lesser Solutions to Perfect Settlement

There are two proposed alternatives to perfect settlement that attempt to address the trade latency issue. Discussed below they are 1) the *Low Latency Solution* and 2) the *High Latency Solution*. Both are inferior to perfect settlement, though the High Latency solution is considerably worse that the Low Latency alternative. They are similar in premise because they both allow a time delay to exist between point of trade execution and point of trade acceptance into clearing; they just differ on how to manage it.

Specifically both alternatives reject proposed CFTC Rule 39.12 (B) (7) that requires that a trade is accepted into clearing immediately upon execution. Instead they both require that a trade, *after execution*, be affirmatively approved by: (1) clearing member of the buyer; (2) the clearing member of

the seller and then lastly; and (3) the DCO before it is accepted into clearing. In essence, the clearing member and DCO must have negotiated a 'last look' option whereby they can reject the trade.

This is an issue, because if the counterparty has its trade rejected due to another's margin insufficiency, the trade may be broken and the non-violating counterparty may suffer economic loss. It must re enter the market to re execute the same trade, albeit with a new functioning counterparty. If a trade is rejected hours after the trade has been executed, as could be the case with certain current DCO candidate workflows, then the non violating counterparty could face significant economic loss or 'breakage.'

Option 1: The Low Latency Solution

The Low Latency solution recognizes that while breaking a rejected trade is suboptimal, it is acceptable if certain conditions are met. The associated economic loss suffered can be minimal if "no trade" is coupled with near immediate notification of trade rejection to the two trade counterparties. If the parties are notified in seconds, economic loss is minimized as it is assumed that the market may have moved little. Thus "breakage" and the cost of executing a new trade to replace the rejected trade is minimized. "Good" trade counterparties can re-enter the market quickly to execute new trades with solvent counterparties that are accepted into clearing. In contrast, "bad" trade counterparties are restricted by both the SEF and their clearing firm from executing further trades.

In certain markets, (e.g. Clearport), such a solution is in place and is considered acceptable because trade rejections rarely occur in market practice.

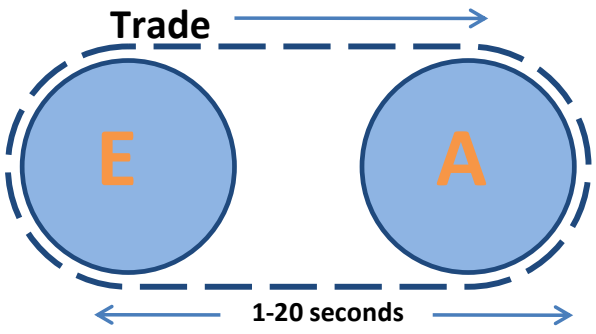

Figure 1.

As seen in above *Figure 1*, where the Low Latency workflow is expressed as a production line conveyor belt, the Commissions would need to ensure that Trade Acceptance ("A") be brought as close as technologically possible to Trade Execution ("E"). It would have to be seconds, to ensure its success.

For this Low Latency model to work, regulators would have to mandate that execution venues (SEFs & DCMs), DCM's work together. As recent industry conflict on this matter has evidenced, that the market, with it's various competing interests and execution models, would somehow voluntarily come together to ensure the success of the Low Latency alternative is an impractical and optimistic expectation.

Importantly, the Commissions should recognize that SEF Core Principle 7 and DCM Core Principle 11 (both entitled *Financial Integrity of Transactions*) may be vague and do not go far enough to ensure that the various competing interests of incumbent dealers, independent FCM's, independent dealers, DCOs, their clearing members & SEFs come together on this matter.

Consequently, to ensure trade integrity under this solution, the Commissions would need to explicitly and prescriptively require that all execution venues (SEFs, DCMs), DCOs and their constituent clearing members (1) utilize current and available technology, and (2) adopt symmetrical post trade workflow to ensure near immediate notice of trade confirmation or rejection.

Importantly, the Commissions would have to mandate that (1) all SEFs deliver both sides of the trade simultaneously directly to the DCO in seconds or milliseconds; (2) all DCOs respond directly in seconds or milliseconds with the trade acceptance or rejection likewise in seconds back to the SEF, such that the SEF could in turn notify the counterparties; and (3) all DCOs establish standards and technological requirements that ensure all clearing members also comply with near immediate trade acceptance/rejection notices in seconds. (See attached Exhibit A entitled *Symmetrical Workflow Diagram*).

Such a requirement would not be unduly burdensome to the market; the SDMA recommends that a phased in approach could be deployed by the Commissions. The market could initially comply with a trade notice in seconds and then graduate to trade notice communication in milliseconds to ensure that customers are protected.

Improving Option 1: The Low Latency Solution with the Pre Trade Margin Check

To further mitigate settlement risk in the Low Latency Option, the Commissions would need to compel the market to adopt a pre-trade customer margin check.

The SEF & DCM could institute such a pre-trade margin check to protect the market from a customer who either *knowingly* or *unknowingly* violates its own margin parameters by initiating a trade that ultimately would be rejected. (See No. 4, Exhibit A attached).

Specifically, the Commissions could compel all clearing members be required to share customer margin information with their DCO who in turn could share it with SEFs or DCMs on a near real-time basis. SEFs, which operate in a neutral agency capacity for the customer, could transmit such information back to the customer so that it does not unknowingly breach its own trading parameters within the DCO. Importantly, through such workflow, customer anonymity would be preserved as customers would see only their own margin information.

To further protect the market from a rejected trade, the SEF could further impose it's own pre trade trading limit with guidance from the DCO and its clearing member to ensure that the customer would not knowingly exceed its own limit and attempt to place a trade order that would certainly result in a trade rejection.

To act as a deterrent, SEFs and DCOs could utilize their authority granted them by the Commissions to impose sanctions and fines on customers who knowingly breach their limits. At a higher level, regulators could also impose fines or take more punitive action on such customers.

It is important to note, that the technology, workflow and connectivity needed to support such a pre-trade margin system exists today and is being deployed and utilized by certain DCOs and SEF execution venues. Such technology uses current connectivity that exists between (1) the DCO and its constituent clearing members, and (2) existing connectivity that exists between the DCO and the execution venue.

Option 2: The High Latency Solution

The second alternative, advocated by certain incumbent dealers, is the High Latency Solution. Unlike Perfect Settlement which removes time delay from the workflow completely and Low Latency that tolerates small time delays in the workflow, the High Latency alternative not only tolerates time delay

but argues that even long time delays (spanning hours or an entire trading day) between point of execution and point of acceptance into clearing are perfectly acceptable.

The High Latency alternative works as follows: (1) the customer executes a trade with a dealer who then submits the trade to the DCO for clearing on behalf of both parties; (2) before the dealer sends the trade to the DCO, however, both parties are given an open time period in which to "confirm" the trade; and (3) once the trade is 'confirmed' it is sent to the DCO, where both the dealer's clearing member and the customer's clearing member then are given another time window in which to accept or reject the trade. These time windows can be hours and can even role into the next trading day. Lastly, In certain DCO workflows proposed, the clearing member is then required to post funds to the DCO. Only then is the trade accepted.

If the trade is rejected, the violating counterparty has the option to submit the trade to a secondary clearing member of the DCO. Again, this action takes more time. If that fails, the parties can agree to "fall back" to an ISDA bilateral agreement between the parties. If the parties do not have an ISDA, the trade can finally be broken and breakage is calculated in accordance with the 2002 ISDA agreement.

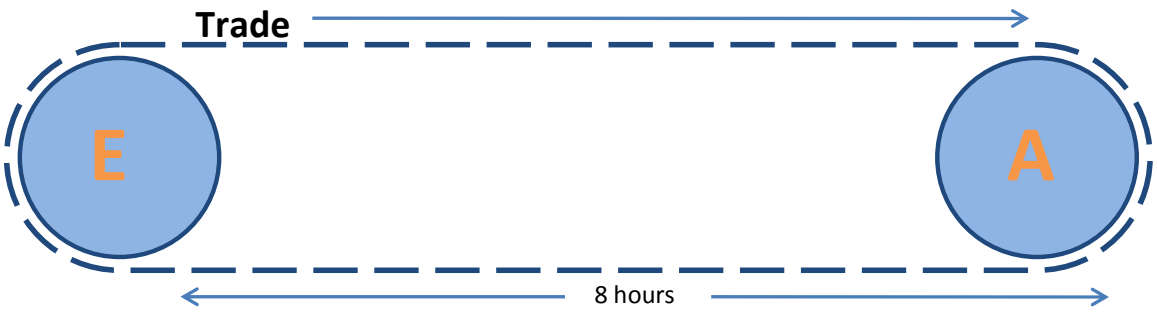

Figure 2.

As illustrated in above *Figure 2*, where the High Latency workflow is expressed as a production line conveyor belt, the proponents of the High Latency model have sought to introduce several steps to stretch out the distance (or time) between Trade Acceptance ("A") and Trade Execution ("E") to as long as 8 hours or even the next trading day.

Some of its proponents accept that the High Latency solution may suffer from certain limitations. To that end, they have suggested a corollary addendum or "Tripartite" solution. The tripartite solution offers a limited version of a pre trade credit check.

Still under discussion, before some incumbents advocate it as a market standard, such a pre-trade credit check would work as follows: (1) the clearing member would set a trading limit on its customer; (2) with the customer's permission, the credit limit would be shared with dealers; (3) the dealer would then check the customer's credit before the trade has occurred and thus no trade would be executed that would likely be rejected; and (4) to avoid two dealers from using up the same credit limit at the same time (and thus having one of their trades being rejected), the customer would have to take its gross credit limit and break it out into sub amounts with each of its dealer counterparties.

The High Latency Solution: Restrictions on Trade

Such a tripartite solution limits customer choice and restricts trade. First, because the per dealer limit decreases with the more dealers you add to the system, it practically limits the number of dealers with whom a customer can trade to no more than a handful. What happens if the customer seeks to trade with 10, 20 or even 30 dealers? With customer choice of dealer counterparty significantly restricted, the market suffers as new dealers cannot enter and compete with incumbents to drive costs lower, increase liquidity and transparency.

Second, such a tripartite solution removes trade anonymity, long held to be a huge benefit of cleared markets, because the customer must now be known to the dealer before the trade.

Third, conflicts of interest now manifest themselves because one principal to the trade -- the dealer –now conveniently, has material information on the other principal—the customer.

Fourth, functionally the tripartite solution restricts 'all to all' and anonymous central limit order book trading, long held to be another benefit to the swaps marketplace, to promote competition, increase transparency, market liquidity and lessen the systemic risk of the OTC derivative market.

Fifth, for the clearing broker to share customer information with its own dealer desk creates a conflict of interest that is expressly forbidden under Sections 731 and 764 of the Dodd Frank Act. These sections create information partitions within the dealer that strictly prohibit their clearing brokers from sharing customer information with their dealer desk counterparts.

Interestingly enough, the pre trading margin check offered under the Low latency solution, (discussed in an earlier section), does not suffer from the same limitations. Because the pre trade check occurs at the neutral SEF or execution venue, there is no limitation on the number of dealers with which a customer can trade. Indeed, the pre trade check is execution method agnostic. Customers can continue to trade anonymously if they so choose, or on whatever platform they so desire. Likewise, there is no conflict of interest between the principals because the customer's credit information is never shared with anyone other than itself and the agent SEF or DCM.

In summary such a tripartite corollary should be seen by the Commissions for what it is—nothing more than a transparent attempt to thwart competition. Simply put, the SDMA believes that it is contrary to the express rules of the Commissions governing Swap Dealers and should be prohibited.

The High Latency Solution: Compliance Limitations for DCOs, SEFs and SDs

Broadly speaking, the SDMA strongly believes that such a High Latency solution suffers from severe limitations because it directly contravenes the express rule sets as promulgated by the Commissions, the Dodd Frank Act, and its specific intent envisaged it's the framers.

The High Latency workflow inserts considerable time delay and numerous linear contingent steps that increase latency and purposefully delay the trade from being accepted into clearing in a timely manner. It is contrary to the Commissions stated intent of "Trade Processing Requirements for Processing, Clearing…" 17 CFR Parts 23, 37, 38 and 39 in which the CFTC correctly asserts that any time delay or latency between the point of execution and the point of trade acceptance into clearing directly constrains liquidity, financial certainty and increases risk.[5]

Specifically, such a workflow violates CFTC Rule 39.12 (B) (7) and the doctrine of perfect settlement that requires that Derivatives Clearing Organizations (DCOs) accept for clearing (1) all eligible swaps trades transacted on Swap Execution Facilities ("SEFs") *immediately upon execution*; and (2) all eligible swaps trades transacted off SEFs *immediately upon trade submission*.

[5] Page 13101. (*Federal Register*, Volume 76, No. 47, 3/10/11).

Moreover, such a workflow inappropriately separates trade *execution* from trade *confirmation* to violate CFTC Rule 37.6 (B) that appropriately requires that the "confirmation of all the terms of the transaction shall take place at the same time as execution." (FR Rule 37.6 (B)).

The High Latency solution contravenes proposed CFTC Rules 23.506, (SDs) 37.702 (SEFs) and 38.601 (DCMs) which require that these entities have the operational capacity to route transactions to DCOs in a real time and that these entities coordinate with DCOs in the "development of rules and procedures to facilitate prompt transaction processing in accordance with Section 39.12 (B) (7)." (FR Rule 23.506, FR Rule 37.702, FR Rule 38.601).

With regard to SEF's, the High Latency solution is contrary to CFTC SEF Core Principle 7—*Financial Integrity of Transactions*. Such a Core Principle requires that the SEF "establish and enforce rules and procedures for ensuring the financial integrity of swaps…including the clearance and settlement of swaps pursuant to Section 2 (h) (1) of the Act." (FR Rule 37.700).

Importantly, the High Latency option would make it impossible for SEF's to comply with SEC and CFTC Core Principle 4--*Monitoring of Trading and Trade Processing that* requires SEFs to conduct real-time monitoring of trading. Clearly, there can be no real-time monitoring of trading, unless trades occur in real-time. Trades do not occur in real-time if there is a delay between execution and clearing.

Moreover, the High Latency option would equally make it difficult to comply with SEC Core Principle 8--*Timely Publication of Trading Information* and CFTC Core Principle 9 --*Timely Publication of Trading Information*. Both core principles require that SEFs report transaction data on timely basis. The current standard for the transmission of transaction data in other markets is real-time. Without mandated immediate acceptance of cleared swaps upon execution there would be a significant delay between the time of trade execution and clearing of swaps that will adversely impact price transparency, and the SEFs' ability to comply with the core principles related to timely publication of trading information.

The lack of real time trade acceptance in the High Latency alternative also limits the SEF's ability to comply with all the core principles that have an audit trial component. These core principles are: (a) SEC Core Principle 3--*Security-Based Swaps not Readily Susceptible to Manipulation* and CFTC Core Principle 3--*Swaps not Readily Susceptible to Manipulation*, (b) SEC and CFTC Core Principle 5 --*Ability to Obtain Information*, (c) CFTC Core Principle 6--*Position Limits or Accountability*; and (d) SEC Core Principle 9--*Recordkeeping and Reporting* and CFTC Core Principle 10 --*Recordkeeping and Reporting*.

Without perfect settlement where trades are accepted into clearing immediately at point of execution, the delay between trade execution and clearing will impede the SEFs ability to maintain an accurate audit trail. This will adversely impact the SEFs' ability to analyze audit trail information to monitor position limits and detect susceptibility to market manipulation.

Not only does the High Latency alternative run contrary to the Commissions' express rules regarding swaps trade settlement and trade integrity, but it also contravenes some of the most basic language of the Dodd Frank Act. The High Latency solution requires that a swaps trade, if rejected, may proceed unbroken by "falling back" to a bilateral, un-cleared trade governed by an ISDA swaps agreement. In this case, the Sections 723 and 763 of the Dodd Frank Act are clear. These sections provide that it is unlawful for any person to engage in a swap or security-based swap unless that person submits such swap or security based swap for clearing to a DCO, if the swap is required to be cleared.

The High Latency Solution: Operational Limitations

Further, the SDMA believes that certain practical limitations exist with regard to the High Latency workflow. Specifically, to force a trade into a bilateral state, which the parties had originally contemplated was to have been cleared, is to *materially* change the terms of the trade in the following ways. First, a bilateral trade has higher capital costs than a cleared trade. Second, a bilateral trade introduces counterparty credit risk that was not contemplated under the original terms of the cleared trade. To change these terms midway requires that a new 'bargain' or price be agreed to by the buyer and seller. Thus, it would be critical to break the first trade and start a new one.

To force the alternative—a cleared trade that now becomes a bilateral trade-- would be not only unworkable, but would be nothing more than a 'bait and switch' that would harm the parties, destroy market integrity and be patently unfair.

Interestingly enough, requiring the use of an ISDA Agreement to save a trade that has been rejected from clearing may not escape one obvious fact ---that the bad counterparty still cannot pay for the trade in the un-cleared state. In practice, trades are rejected not because the offending counterparty cannot pay for the trade same day. It is because the counterparty's clearing broker reasonably expects that the offending counterparty will not be able to pay for the trade next day or any day thereafter. Thus, to somehow force a counterparty into a bilateral trade with a non credit worthy

counterparty seems an unfair cure that benefits the offending counterparty at the direct expense of the compliant counterparty. Simply put, having an ISDA Agreement in place with an insolvent counterparty does not improve a counterparty's chance of getting paid on the trade.

In conclusion, while the High Latency Solution may protect certain incumbent dealer interests and attempt to restrict competition and market choice, it is certainly the most inferior alternative when compared to both 1) the Low Latency Solution and 2) the Perfect Settlement Solution as contemplated by the Commissions Rules in sections 17 CFR Parts 23, 37, 38 and 39.

In Preparation for the Perfect Settlement Solution

The Commissions should recognize that current proposed workflows at certain DCOs do not presently require tight response time frames and certain approved workflows may actually impede real-time confirmation. For example, certain DCOs presently fail to acknowledge CFTC Rule 37.6 (B) that appropriately requires that the "confirmation of all the terms of the transaction shall take place at the same time as execution." Instead, these DCOs assert trade confirmation can only occur *after* execution when additional information is added later in the workflow either at third party middleware systems or indeed at the DCO itself. Adding such information after execution not only violates CFTC Rule 37.6, but can slow or, more dangerously, halt the workflow from continuing. More specifically, if both buyer and seller are required to 'approve' the trade on a middleware system what happens if one party does not? Such trade counterparties could force the trade to remain purposely in an 'unconfirmed' state at the direct expense of the non offending counterparty.

The Commissions should also be cognizant that certain DCOs presently do not offer a direct application program interface ("API") connectivity through which a SEF or execution venues can directly connect to settle trades. Instead, these swap DCOs offer connectivity and trade confirmation only via third party middleware systems. Such middleware systems may add extra steps to the workflow or add unnecessary communication latency thus increasing time delay and undermining trade certainty.

The SDMA recommends that following rules be amended to address this important issue. To support proposed rule 37.702 "General Financial Integrity", which requires swap execution facilities to have the capacity to route transactions to a derivative clearing organization ("DCO"), the SDMA recommends the CFTC add a corresponding requirement in Part 39 for DCOs to provide direct

connectivity, via a direct API connection, for swap execution facilities. We also urge the SEC to mandate direct connectivity between clearing agencies and security-based swap execution facilities by amending (a) proposed Part 240 and (b) section 242.815 "Financial Integrity of Transactions" of the proposed rules for security-based swap execution facilities.

Importantly, the Commissions should be mindful that although market participants intellectually appreciate the universal benefits of central clearing and open access, it is an impractical assumption to believe that competing market interests will work together because their Core Principles require it. The Commissions must stay ever vigilant to ensure that central clearing takes hold in the OTC swaps marketplace. The Commissions should be mindful not to allow any proposed workflow be restrictive or represent an anticompetitive restraint on customer choice of counterparty or execution method. Nor should it be a restraint on a buyer's or seller's choice of clearing firm. Consistent with the Commissions intent, any proposed workflow must increase, not decrease, the speed at which a trade is confirmed.

Conclusion

The SDMA supports current proposed Commissions' rules that seek to strengthen the financial integrity of the cleared swap markets by addressing the trade latency issue by imposing certain uniform standards for prompt processing, submission and trade acceptance into clearing. Settlement uncertainty, caused by time delays between the point of *trade execution* and the point of *trade acceptance into clearing*, could destroy confidence in the cleared OTC derivatives markets. As the CFTC has correctly asserted, such a time delay or 'trade latency,' (which in the bilateral swaps markets can be as long as a week) directly constrains liquidity, financial certainty and increases risk.[6]

In consideration of the various market alternatives discussed above, including inferior market solutions that add unnecessary latency or time delay to exist whether for a long or short time, the SDMA strongly believes that the Commissions adopt in their entirety proposed CFTC Rule 39.12 (B) (7) that requires that DCOs accept for clearing 1) all eligible swaps trades transacted on SEFs *immediately upon execution* and; 2) all eligible swaps trades transacted off SEFs *immediately upon trade submission*. Importantly, the SDMA respectfully requests that the Commissions properly clarify Rule 39.12 (B) (7) consistent with their original intent of ensuring market adoption of 'Perfect Settlement.'

[6] Page 13101. (*Federal Register*, Volume 76, No. 47, 3/10/11).

Simply put, to conquer the issue of latency is to remove it completely.

Moreover, the SDMA respectfully requests that the Commissions mandate all such rules currently before them that compel Swap Dealers, Major Swap Participants, Derivative Clearing Organizations, their constituent clearing members, Swap Execution Facilities, DCMs and ECPs to comply with the established market doctrine of Perfect Settlement.

Respectfully Submitted,

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Exhibit A: Symmetrical Workflow