



SWAPS & DERIVATIVES MARKET ASSOCIATION

August 8, 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: Adaptation of Regulations to Incorporate Swaps; Proposed Rule 1.35
17 CFR Parts 1, 5, 7, 8, 15, 18, 21 36 41, 140 145, 155 and 166, RIN Number 3038-AD53

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 the process for handling bunched swaps orders contain in proposed Rule 1.35, which is contained, among other things, in the proposed rule making entitled “Adaptation of Regulations to Incorporate Swaps”, 17 CFR Parts 1, 5, 7, 8, 15, 18, 21 36 41, 140 145, 155 and 166.

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

The SDMA supports the proposed rule for bunched orders being executed in full and then allocated on a post trade basis as stated in Rule 1.35 “Records of commodity interest and cash commodity transactions”. In order for post trade allocations to work effectively, bunched orders must be treated the same at execution as other orders so that they can be accepted in to clearing on a real time basis thus insuring the integrity of the entire transaction. Since the allocation of bunched trades is handled after execution, the process of allocation is entirely between the customer and its FCM. Under no circumstances should the allocation process be the reason for a trade being delayed for acceptance into clearing.

Specifically, proposed Rule 1.35 (a) creates a single standard for who is permitted to allocate bunch orders (i.e.; an agent authorized by the customer), (b) set post trade deadlines for the allocation of bunched orders based upon type of transactions (i.e.; cleared transactions must be allocated no later than “time sufficiently before the end of the day the order is executed to ensure that clearing records identify the ultimate customer for each trade”, and uncleared trades must be allocated by end of the calendar day of execution); (c) defines what information must be provided to customers about the allocation process and creates detailed recordkeeping requirements; (d) requires that allocations be fair and equitable, and “sufficiently objective to and specific to permit independent verification of the fairness of allocation”; and (e) prohibits Futures Commission Merchants (“FCMs”) and Introducing Brokers (“IBNs”) from including proprietary trades in a bunched order with customer trades. We believe that proposed Rule 1.35 will enhance market integrity as a result of increased certainty of the status of bunched orders and transparency regarding the allocation process.

The Process Regarding Bunched Orders is Supported by Long Standing Precedent

The SDMA believes that the proposed time deadlines, that require that the allocation of cleared transactions should be no later than the “time sufficiently before the end of the day [on which] the order is executed to ensure that clearing records identify the ultimate customer for each trade” and the allocation of uncleared trades by end of the calendar day of execution, are well supported by industry precedent.

The futures markets provide an important precedent for cleared swaps processing. They have a long history of handling bunched orders in a prompt, efficient and accurate manner. The CFTC correctly

notes in its discussion of proposed Rule 1.35 that "... bunched order procedures currently applicable to futures can be adapted for use in swap trading" and that there should be a single standard for all intermediaries. (76 FR 33073) We agree with the CFTC's adopting of time deadlines in proposed Rule 1.35 that are "... similar to the current procedure for futures, [where] the allocation be completed by the end of the day of execution and provided to the counterparty" (76 FR 33073) is the optimal approach to structure the handling of bunched orders.

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. Asset manager customers that routinely trade on behalf of multiple entities will 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.

For Proposed Rule 1.35 to be Effective it Must be Consistent Other Rules Related to Trade Processing

The SDMA believes that the allocation of bunched orders is a post-execution event. The success of proposed Rule 1.35 is dependent upon the extent to which it is consistent with other rules regarding swap trade processing and clearing. With respect to transactions executed on a swap execution facility ("SEF") and subject to mandatory clearing, a transaction must be confirmed immediately upon execution (proposed Rule 37.6(b)). The trade should clear "... as quickly after execution as would be technologically practicable..." (proposed Rule 39.12(b)(7)(ii)). The proposed rules make it clear that the CFTC correctly asserts that such processing be real time or near immediate in milliseconds or seconds, and not hours or days. (76 FR 45733) Any inconsistency in the proposed rules would undermine trade integrity and deny market participants the operational and cost efficiencies that result from the use bunched trades.

The Post Trade Allocation of Bunched Orders

In the futures markets, the allocation of bunched orders takes place strictly on a post trade basis. The allocation is typically performed by the investor manager directly with the FCM on behalf of the customer sub account. At the time of allocation, the trade has already been accepted for clearing. Any post trade issues are worked out between the FCM and the customer. In addition, 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 designated contract market, only the allocating party need concern itself with its own *allocation*. The SDMA believes that the same approach should be used in the swaps market.

There can be no uncertainty as to whether a trade has been accepted for clearing at the time of allocation. In no event should the regulators permit the allocation process to become an opportunity for the late rejection of a trade for clearing.

Arguments that “Futures Style” Allocations will not work in the Swaps Market are Without Merit

Some discussion has been raised that swaps represent a different set of risks from both a product and operational stand point. Such arguments may be too simplistic in their thinking.

While swaps may be different than futures in their average trade size and more bespoke in their contract details, the ability to model and hedge swap risk is highly developed and the use of futures markets as offsetting hedges for swap transactions is common and routine. The ability for swaps to be hedged using a strip of offsetting futures allows for a large institutional transaction to be traded out to a duration neutral position. This allows for the efficient and liquid transfer of risk. Processing one large trade or a series of smaller trades that equate to the same risk profile does not make swaps trading less manageable.

Moreover, differences in the risk profile of swaps and futures, as they pertain to clearing, are extraneous to a large extent. The risk inherent in a cleared swap trade is reflected in the margin requirement set by the risk committee at the clearing house. This is where the economic differences in the product’s risk profile are considered. The FCM will maintain its role of ensuring that it monitors its customer’s risk and has adequate margin to protect against such risk. If the FCM can access its customer’s trade activity on a real time basis, then its ability to maintain prudent risk controls is ensured.

Because swap execution venues are separate from clearing houses under the Dodd Frank Act, certain market participants have voiced concerns that clearing brokers will be less likely to guarantee a customer’s trade at point of execution or might charge more for the service. Futures markets largely function by combining trade execution on an exchange and clearing at an affiliated clearing house; also

known as “vertical integration.” For the cleared OTC derivatives market, however, swaps may be executed at SEFs, which may not always be owned or affiliated with a clearing house; also known as “horizontal integration.” Since no common ownership or affiliation may exist between the SEF and the clearing house, the belief is that the clearing member will not have the ability to monitor or impose risk controls via the SEF on its customer.

But having no common ownership or affiliation should not preclude the SEF and clearing member from establishing real time connectivity where such risk controls and monitoring are properly available. Already today, certain SEFs and clearing houses currently offer FCMs the ability to monitor and control their customer’s risk. Using existing technology FCMs can:

- 1) Set risk limits directly at SEFs-both simple and complex;
- 2) Monitor trade activity including open orders;
- 3) Disallow trading via a “kill” switch.

With recent rules proposed on August 1st 2011, the Commission has appropriately called for such risk controls to exist between the SEF and the clearing firm, mandating that clearing members have “... procedures to limit the financial risks they incur as a result of clearing trades and liquid resources to meet the obligations that arise.” (76 FR 45726)

The technology for this type of real time risk monitoring exists today. It is offered by third party technology vendors who provide electronic execution capabilities and is available at certain SEFs and clearinghouses. Since FCMs will have fully integrated visibility to their account’s risk, their willingness to process that risk will be consistent with their other vertically connected products. As such, the ability and the willingness of an FCM to perform post-execution allocations will be a matter of level of *service* not level of *risk*.

Conclusion

The SDMA supports the proposed rules which take proven elements from the futures markets and apply them to the cleared swap markets. Allowing customers to effect efficient and low latency transactions is critical to ensure the success of the cleared swap market.

Using bunched trades promotes execution and operational efficiency. Bunched trades can be allocated on a post trade basis, as they are today in both bilateral and exchange traded environments.

The necessity of maintaining risk controls mandates that bunched trade allocation can be complete by the end of the trading day. In order for this process to maintain the integrity of trades and not create undue latency, bunched trades must be treated like all trades with an immediate confirmation of trade detail at point of execution and upon real time acceptance into clearing. By utilizing existing technology, the monitoring of risk and the management of margin is consistent across vertically designed execution and clearing venues as well as horizontally designed systems thus allowing for the application of efficient work flow such as post-execution trade allocations.

Respectfully Submitted,

A handwritten signature in blue ink, appearing to read 'James Cawley', with a stylized flourish at the end.

James Cawley
Co Founder
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