SDMA SWAPS & DERIVATIVES MARKET ASSOCIATION

September 30th, 2011

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

Re: RIN No. 3038–AD51: Customer Clearing Documentation and Timing of Acceptance for Clearing;
RIN No. 3038–AD51: Clearing Member Risk Management

Dear Mr. Stawick:

The Swaps & Derivatives Market Association ("SDMA") appreciates the opportunity to provide comments to the Commodity Futures Trading Commission (the "CFTC") on the CFTC's Notice of Proposed Rulemaking regarding with regard to CFR Parts 1, 23, and 39 Customer Clearing Documentation and Timing of Acceptance for Clearing.

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 the 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, real time trade acceptance into clearing, requiring certain clearing member risk management tools & restricting possible anti competitive behavior while promoting open access. Specifically, the SDMA respectfully requests that the CFTC in their entirety adopt additional proposed rules A) 1.72 & 23.608 with regard to customer clearing documentation ("Proposed Documentation Rules"), and B) proposed rules 1.74, 23.610, 39.12 with regard to real time trade acceptance into clearing of swaps trades ("Proposed Real Time Acceptance Rules") and C) rule 1.73 with regard to Clearing Firm risk management ("Proposed Risk Management Rules").

In Support of Real Time Trade Acceptance Rules

The Proposed Real Time Acceptance Rules require that a clearing member or the derivatives clearing organization ("DCO") accept swaps trades "as quickly as would be technologically practicable" where the standard will be in "milliseconds or seconds or, at most, a few minutes, not hours or days." [3] The SDMA supports such rules because they will ensure enhanced market integrity by removing settlement uncertainty that can occur from an uncleared swaps trade. As evidenced from other cleared markets, removing trade uncertainty from the trade workflow fosters a substantially more liquid, more dynamic and open market place.

The Proposed Real Time Acceptance rules will also promote the growth and trading volumes on Swap Execution Facilities ("SEFs"), a key goal of the Dodd Frank Act of 2010 (the "DFA"). Whether such SEFs offer low latency, anonymous *Central Limit Order Book* ("CLOB") execution or less robust *Request for Quote* ("RFQ") execution, the SDMA firmly believes that the CFTC's settlement standard required of DCOs, their constituent clearing members be the exact same.

[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).
[3] Page 1. (CFTC Fact Sheet: "Proposed Rule on Customer Clearing Documentation and Timing of Acceptance for Clearing," August 3rd 2011).

Moreover, the SDMA believes that the Proposed Real Time Acceptance Rules should be 'milliseconds or seconds,' because such a low latency time period or indeed having no time window at all (where trades are accepted *immediately into clearing*) is already the standard for other cleared swaps and futures markets in the United States and as such, would not be unduly burdensome for the cleared interest rate and credit default swap markets to adopt.

To support the notion of well functioning real time clearing models that already operate in the US and comply with the CFTC's Proposed Real Time Acceptance Rules albeit for other markets, consider the Clearport or "Low Latency" Solution.

Clearport/Low Latency Solution

Launched by the CME in 2002 for the cleared energy swaps market, Clearport serves the mostly bilateral energy swaps trading marketplace where customers can trade with each other and dealers alike. Clearport's settlement procedure requires that a trade, once executed, 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 has a 'last look' option whereby they can reject the trade. If the swaps trade is rejected by either clearing member, due to customer margin insufficiency, the accepted market protocol is that there is <u>no trade</u> and no obligation exists between the parties.

Such a system works extremely well because it is a low latency solution where Clearport and it's clearing members notice the counterparties of trade acceptance/rejection in <u>milliseconds</u>. If the parties are notified in milliseconds, 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 from executing any further trades.

In theory bad trades can occur, but in practice, such swaps trades have rarely been rejected, as market participants generally solve any trade issues on an intraday basis. Moreover, clearing members have certain risk management tools to enforce customer trade limits directly at the DCO and in real time. Albeit reactively and *strictly on a post trade basis*, such limits known as Risk Allocation Values ("RAVs") have served the cleared energy swaps market so far.

It is important to note that Clearport requires <u>no execution documentation</u> for its participants.

In conclusion, with regard to the Proposed Real Time Acceptance Rules, the SDMA respectfully requests that the CFTC adopt such a rule set in their entirety because real time trade acceptance, as evidenced directly in the Clearport example, lessens trade uncertainty, builds market confidence and substantially promotes more liquidity, Importantly, such a rule would also promote the success of SEF's (irrespective of execution model) and encourage open access to the interest rate and credit default swap markets.

In Support of Proposed Risk Management Rules

The Proposed Risk Management Rules require that the clearing member 1) set risk based customer limits 2) monitor such customer limits and 3) prescreen & monitor customer orders such that they do not exceed such limits. [4] The CFTC mandate that the clearing member "see all working orders and filled orders for intraday risk management or with a "kill button" that cancels all open orders for an account…"[5] Other related rules will require that clearing members test customer account liquidation costs, and routinely conduct certain stress testing .

The SDMA supports such rules and recommends that the CFTC adopt such rules in their entirety. Such rules further mitigate settlement risk by encouraging DCOs and their constituent clearing members to conduct a pre-trade customer margin check. DCOs, clearing members and execution venues will now proactively consider trades at the *unfilled* order stage in the workflow before they become possible 'bad' trades that would be ultimately rejected later and thus lessen market integrity.

Improved risk management by use of these pre trade tools will also foster greater market efficiency and remove the need for bilateral execution documentation or credit intermediation between the parties.

Importantly though, such tools, as noted in the Clearport example, are already commonplace in many other cleared markets. Other markets where such pre trade limit checks occur and such risk tools are routinely used are the Globex/WebICE examples.

Globex/WebICE & Perfect Settlement

CME's Globex (US treasury and Eurodollar futures) and ICE's WebICE (energy swaps) both offer CLOB electronic execution as well as clearing. Both trade venues permit the clearing member to directly set customer trading limits on the execution platform itself. Clearing firms can monitor and set order limits real time and adjust them during the trading session. Because customer orders are pre-screened, any

[4] Rule 1.73 Page 45729. (*Federal Register*, Volume 76, No. 47, 8/1/11).
[5] Page 1. (CFTC Fact Sheet: "Proposed Rule on Clearing Member Risk Management," August 3rd 2011).

trades resulting from such orders are pre-approved and accepted into clearing immediately upon execution.

If the clearing member wishes to prevent it's customer from entering an order that my result in the customer exceeding it's limit, the clearing firm simply adjusts its customer limit directly at the execution venue or cuts the customer off completely by means of a 'kill switch.'

With such a 'perfect settlement' solution, no latency exists between *point of execution* and *point of acceptance into clearing* and consequently, market integrity is assured.

It is interesting to note that WebICE also requires no bilateral execution documentation between counterparties.

Perfect Settlement

To be clear, with the protocol of 'perfect settlement,' clearing members, who otherwise may have no incentive to utilize trading platform pre-trade risk tools are incented to use them, because they are ultimately responsible for their customer's trade. Should the clearing member not monitor its customer and were a 'bad' trade to enter the market place from a defaulted customer, the clearing broker would be required to make the opposing trade counterparty whole.

It is functionally proper and appropriate that clearing members have the ability to restrict its customer's trading by means of prudent risk management tools at the execution venue or SEF. However, 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, 'dial down' the customer or cut him off completely from execution by means of the kill switch at the SEF. By taking these proactive actions to protect itself, the clearing member protects the execution venue, other customers and the market as a whole.

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.

The SDMA supports the Proposed Risk Management Rules because they are prudent, work in other market cleared markets and are well known to market participants to promote trade efficiency and ensure trade integrity. Because they are deployed in many other markets, they could easily, cheaper and quickly scale into the cleared interest rate swap and credit default swaps markets.

Proposed Risk Management Rules Consistent with CFTC PFS Committee Recommendations

The SDMA supports the Proposed Risk Management Rules because they are also all largely consistent with the recommendations proposed by the CFTC's Pre Trade Functionality Subcommittee of the CFTC Technology Advisory Committee (the "PFS") published March 1st, 2011.

Charged with recommending pre trade measures, the PFS was careful to make certain recommendations that preserved market integrity and market innovation, but that included all levels of the trade 'supply chain,' such that no firm could be unfairly advantaged by offering inferior controls and thus compelling a race to the bottom, thus undermining market trade settlement certainty.

The PFS recommended 1) Pre trade quantity limits on individual customers; 2) Pre trade price collars to prevent erroneous 'fat finger' order entry; 3) Execution Throttles; 4) Message Throttles and lastly 5)'Kill Buttons,' as proposed by Proposed Risk Management Rules such that clearing firms had the capability to cancel existing customer orders, and to prevent new orders from being placed that might otherwise throw a customer's limit.

Proposed Rules Consistent with SEF Core Principles

The proposed Real Time Trade Acceptance Rules and Risk Management Rules (the "Proposed Rules") are also consistent with the Commission rules for SEFs. 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.

The Proposed Rules are also consistent with CFTC SEF Core Principle 7—*Financial Integrity of Transactions*.[6] 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 the Proposed Rules whereby clearing members pre authorize 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.

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

Indeed, without the Proposed Rules where trades are accepted in real time, SEFs will find it difficult to comply with other Core Principles that have any 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.[7] 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 any 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 real time acceptance of swaps into clearing there would be a significant delay between the time of trade execution and clearing that will adversely impact the SEFs' ability to comply with the core principles related to timely publication of trading information.

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[6] 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".

[7] 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".

Real time acceptance 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 real time trade acceptance, 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.

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.

Proposed Rules work well for Trade Allocations

The SDMA respectfully requests that the CFTC adopt the Proposed Rules because they will allow for the efficient and timely settlement of "bunched" trades or trades with a trade allocation component.

As empirically evident from other cleared markets, it is well established that real time trade 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 of accepting trades in real time. 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.

Real time trade 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 the Real Time Trade Acceptance Rules and Proposed Risk Management Rules. By both requiring that trades be accepted into clearing in real time and requiring pre trade risk tools such that bad trades are prevented before they are executed, the CFTC has diligently addressed the issue of trade uncertainty that exists 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 real time trade acceptance.

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 as proposed.

In Support of Proposed Documentation Rules

The Proposed Documentation Rules prevent certain CFTC registrants (FCMs, swap dealers, and major swap participants) from entering into an arrangement with a customer that would 1) limit the number of counterparties with whom the customer may trade; 2) restrict the size of the position a customer may take with any individual counterparty; 3) impair a customer's access to trade execution on terms

that have a reasonable relationship to the best terms available; 4) prevent compliance with real time trade acceptance and lastly 5) prevent disclosure of the identity of a customer's original executing counterparty.

The SDMA supports such Proposed Documentation Rules and respectfully requests that the CFTC adopt such rules in their entirety.

While the SDMA is philosophically loathe to encourage possible government 'inference' with private contracts between two parties, the SDMA sees no conflict with these rules when such contracts would either 1) directly or indirectly contract the rights away of a third party without its knowledge or consent; or 2) when such a contract would restrict trade by limiting a customer's choice of counterparty, trading venue, impair a customer access to execution on the best terms available or necessitate disclosure of the identity of a customers counterparty.

Nor does the SDMA believe that the CFTC is being too prescriptive. To be clear, the CFTC is not preventing private parties or industry groups from entering into or sponsoring certain contracts, the CFTC is merely exercising it's duty to ensure that such contracts are not anti-competitive, and are in full compliance with laws of the United States in general and the Dodd Frank Act in particular.

It is well established that government and its regulators have *explicit* authority to intervene in markets and their workflows to ensure fair dealing, market integrity and to prevent such markets from manipulation and fraud.

Moreover, the SDMA believes that the CFTC is both empowered and required to adopt such Proposed Documentation Rules under anti trust considerations of the Dodd Frank Act. The DFA requires that regulators ensure that a "a swap dealer or major swap participant shall not-(A) adopt any process or take any action that results in any unreasonable restraint of trade; or (B) impose any material anticompetitive burden on trading or clearing." [8]

To limit the number of customer counterparties or choice of execution venue, or to limit the positions a customer may take with a counterparty, or to restrict a customer's access to best execution clearly serves no legitimate risk interest, is not required in other cleared swaps and futures markets and most certainly does impose an unreasonable restraint on trade prohibited under the DFA.

Moreover to expose the identity of a customer's original executing counterparty to a third party, (for example a dealer) is expressly forbidden under that DFA. Under the Act, the Commission shall require that dealers "establish structural and institutional safeguards to ensure that the activities of any person within the firm… acting in a role of providing clearing activities … is separated by appropriate

[8] Commodities Exchange Act. Sec 4s (j) (6). July 21, 2010.

informational partitions … from the review, pressure, or oversight of persons whose involvement in pricing, trading, … might potentially bias their judgment or supervision and contravene the core principles of open access…"[9] Simply put dealers cannot exchange client information with it's clearing member division.

For the CFTC to allow such contracts to go forward would dangerously inhibit the swaps market's successful migration to the clearing. The market's full 'democratization,' as was the original intent of the DFA would not occur. Liquidity would be dangerously restricted, as customers would be precluded from trading with multiple dealers and other counterparties. Agency intermediaries or swap brokers, so vital to liquidity and transparency in the futures markets, could not exist as trade principles could intermediate trades directly.

Importantly, anonymous trade exchanges and electronic CLOB SEFs could not exist because customers would be restricted from trading in 'all to all' trading environments, and instead their identity would be known and their counterparty choice limited. Trade latency would now reign as dealers and DCOs saw no incentive to innovate. The swaps market would not enjoy the well established benefits of exchanges and electronic platforms such as substantially more liquidity, broader market participation and lessened systemic risk.

Nor could small market participants benefit from lowered transaction costs and access to multiple trade counterparties, so vital in times of market stress.

In conclusion, the SDMA supports the CFTC adoption of the Proposed Documentation Rules and believes that it is appropriate and proper that the CFTC adopt such rules to ensure that the customer enjoys the same execution rights offered in other cleared swaps and futures markets and that the customer suffers no unreasonable restraints on trade.

Cost & Benefits

With regard to the costs & benefits of adopting such rules, the benefits cannot be understated. By the speedy adoption of such rules, capital formation and private enterprise shall immediately go to work to directly import the well established benefits of trade workflows & systems enjoyed in other cleared swaps and futures markets. By allowing real time trade acceptance, and multiple trading venues and dealers to compete with each other in the market place, liquidity and transparency shall greatly increase and transaction costs shall dramatically lower. The SDMA estimates that such lowered transaction costs

[9] Commodities Exchange Act. Sec 4s (j) (5). July 21, 2010.

are worth at least $15 Billion annually to corporate America. With such funds held on the balance sheet's of the end user, such firms will be able to invest in more research and development and hire more workers.

Conclusion

The SDMA supports the 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, real time trade acceptance into clearing, requiring certain clearing member risk management tools & restricting possible anti competitive behavior while promoting open access. Specifically, the SDMA respectfully requests that the CFTC in their entirety adopt additional proposed rules A) 1.72 & 23.608 with regard to customer clearing documentation ("Proposed Documentation Rules"), and B) proposed rules 1.74, 23.610, 39.12 with regard to real time trade acceptance into clearing of swaps trades ("Proposed Real Time Acceptance Rules") and C) rule 1.73 with regard to Clearing Firm risk management ("Proposed Risk Management Rules").

Moreover, the SDMA respectfully asks that the CFTC place ultimate priority on these rule sets above all others in the final rule implementation process, so that the industry can enjoy greater certainty and continue its investment in the swap markets migration to cleared environment.

Respectfully Submitted,

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cc: The Hon. Gary Gensler, Commission Chairman
The Hon. Michael Dunn, Commission Commissioner
The Hon. Bart Chilton, Commission Commissioner
The Hon. Jill E. Sommers, Commission Commissioner
The Hon. Scott D. O'Malia, Commission Commissioner