COMMODITY FUTURES TRADING COMMISSION

17 CFR Parts 1, 23, 37, 38, and 39

RIN 3038-0092, -0094

Customer Clearing Documentation, Timing of Acceptance for Clearing, and Clearing Member Risk Management

AGENCY: Commodity Futures Trading Commission.

ACTION: Final rule.

SUMMARY: The Commodity Futures Trading Commission ("Commission" or "CFTC") is adopting rules to implement new statutory provisions enacted by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act. These rules address: the documentation between a customer and a futures commission merchant that clears on behalf of the customer; the timing of acceptance or rejection of trades for clearing by derivatives clearing organizations and clearing members; and the risk management procedures of futures commission merchants, swap dealers, and major swap participants that are clearing members. The rules are designed to increase customer access to clearing, to facilitate the timely processing of trades, and to strengthen risk management at the clearing member level.

DATES: The rules will become effective October 1, 2012.

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I. Background

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[1] Title VII of the Dodd-Frank Act amended the Commodity Exchange Act ("CEA" or "Act")[2] to establish a comprehensive new regulatory framework for swaps. The legislation was enacted to reduce risk, increase transparency, and promote market integrity within the financial system by, among other things: (1) providing for the registration and comprehensive regulation of swap dealers and major swap participants; (2) imposing clearing and trade execution requirements on standardized derivative products; (3) creating rigorous recordkeeping and real-time reporting regimes; and (4) enhancing the Commission's rulemaking and enforcement authorities with respect to, among others, all registered entities and intermediaries subject to the Commission's oversight. Title VII also includes amendments to the federal securities laws to establish a similar regulatory framework for security-based swaps under the authority of the Securities and Exchange Commission ("SEC").

A fundamental premise of the Dodd-Frank Act is that the use of properly regulated central clearing can reduce systemic risk. Another tenet of the Dodd-Frank Act is that open access to clearing by market participants will increase market transparency and promote market efficiency by enabling market participants to reduce counterparty risk and by facilitating the offset of open positions. The Commission has adopted extensive regulations addressing open access and risk management at the derivatives clearing organization ("DCO") level.[3]

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[1] See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).
[2] 7 U.S.C. 1 et seq.
[3] Derivatives Clearing Organization General Provisions and Core Principles, 76 FR 69334 (Nov. 8, 2011).

Clearing members provide the portals through which market participants gain access to DCOs. Clearing members also provide the first line of risk management. Accordingly, in three related rulemakings, the Commission proposed regulations to increase customer access to clearing,[4] to facilitate the timely processing of trades,[5] and to strengthen risk management at the clearing member level.[6] In addition, in a fourth rulemaking, the Commission proposed regulations relating to the allocation of bunched orders.[7] The Commission is issuing final rules in each of these areas.

More specifically, the regulations contained in this Adopting Release were proposed in four separate notices of proposed rulemaking ("NPRMs"). Sections 1.72, 1.74, 23.608, 23.610, 39.12(a)(1)(iv), and 39.12(b)(7) were proposed in Customer Clearing Documentation and Timing of Acceptance for Clearing,[8] sections 23.506, 37.702(b), and 38.601(b) were proposed in Requirements for Processing, Clearing, and Transfer of Customer Positions,[9] sections 1.73 and 23.609 were proposed in Clearing Futures Commission Merchant Risk Management,[10] and 1.35(a-1)(5)(iv) was proposed in Adaptation of Regulations to Incorporate Swaps.[11] The Commission is finalizing the rules contained in this Adopting Release together because they address three overarching, closely-connected aims: (1) non-discriminatory access to counterparties and clearing; (2) straight-through processing; and (3) effective risk management among clearing members. Each of these provides substantial benefits for the markets and market participants.

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[4] Customer Clearing Documentation and Timing of Acceptance for Clearing, 76 FR 45730 (Aug. 1, 2011).
[5] Requirements for Processing, Clearing, and Transfer of Customer Positions, 76 FR 13101 (Mar. 10, 2011).
[6] Clearing Member Risk Management, 76 FR 45724 (Aug. 1, 2011).
[7] Adaption of Regulations to Incorporate Swaps, 76 FR 33066 (Jun. 7, 2011).
[8] See 76 FR 45730 (Aug. 1, 2011).
[9] See 76 FR 13101 (Mar. 10, 2011).
[10] See 76 FR 45724 (Aug. 1 2011).
[11] See 76 FR 33066 (Jun. 6, 2011).

II. Customer Clearing Documentation

A. Introduction

As discussed in the notice of proposed rulemaking,[12] industry groups have developed a template for use by swap market participants in negotiating execution-related agreements with counterparties to swaps that are intended to be cleared.[13] The template includes optional annexes that make the clearing member to one or both of the executing parties a party to the agreement (the trilateral agreements). The trilateral agreements contain provisions that would permit a customer's futures commission merchant ("FCM"), in consultation with the swap dealer ("SD") that is the customer's counterparty, to establish specific credit limits for the customer's swap transactions with the SD. The provisions further provide that the FCM will only accept for clearing those transactions that fall within these specific limits. The limits set for trades with the SD or MSP might be less than the overall limits set for the customer for all trades cleared through the FCM. The result would be to create a "sublimit" for the customer when trading with that SD or MSP.

When a trade is rejected for clearing, the parties to that trade may incur significant costs. As the clearing of swaps increases pursuant to the Dodd-Frank Act, the likelihood and size of such potential costs could also increase, according to the proponents of the trilateral agreements. The trilateral agreements were intended to limit these potential costs.

The Commission expressed concern in the notice of proposed rulemaking that such arrangements potentially conflict with the concepts of open access to clearing and

[12] See 76 FR 45730 at 45731, Aug. 1, 2011.
[13] See http://www.futuresindustry.org/downloads/ClearedDerivativesExecutionAgreement_June142001.pdf.

competitive execution of transactions.[14] To address these concerns and to provide further clarity in this area, the Commission proposed § 1.72 relating to FCMs, § 23.608 relating to SDs and MSPs, and § 39.12(a)(1)(vi) relating to DCOs. These regulations would prohibit arrangements involving FCMs, SDs, MSPs, or DCOs that would (a) disclose to an FCM, SD, or MSP the identity of a customer's original executing counterparty; (b) limit the number of counterparties with whom a customer may enter into a trade; (c) restrict the size of the position a customer may take with any individual counterparty, apart from an overall credit limit for all positions held by the customer at the FCM; (d) impair a customer's access to execution of a trade on terms that have a reasonable relationship to the best terms available; or (e) prevent compliance with specified time frames for acceptance of trades into clearing.

B. Summary of Comments

The Commission received a total of 38 comment letters directed specifically at the proposed documentation rules.[15] Of the 38 commenters, 30 supported the proposed

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[14] Id. at 45732.

[15] Comment files for each proposed rulemaking can be found on the Commission website, www.cftc.gov. Commenters include: Chris Barnard ("Barnard"); MarkitSERV ("Markit"); Swaps & Derivatives Market Association ("SDMA"); Better Markets; IntercontinentalExchange, Inc. ("ICE"); ISDA FIA ("ISDA"); The Alternative Investment Management Association Ltd. ("AIMA"); CME Group Inc. ("CME"); Morgan Stanley; Edison Electric Institute ("EEI"); State Street Corporation ("State Street"); New York Portfolio Clearing ("NYPC"); Asset Management Group of the Securities Industry and Financial Markets Association ("SIFMA");; Vanguard; AllianceBernstein L.P. ("Alliance Bernstein"); Minneapolis Grain Exchange, Inc. ("MGEX"); Atlantic Trading USA LLC; Belvedere Trading; Bluefin Trading, LLC; Chopper Trading LLC; CTC Trading Group, LLC; DRW Holdings, LLC; Eagle Seven, LLC; Endeavor Trading, LLC; Flow Traders US LLC; Geneva Trading USA, LLC; GETCO; Hard Eight Futures; HTG Capital Partners; IMC Financial Markets; Infinium Capital Management LLC; Kottke Associates, LLC; Marquette Partners, LP; Nico Holdings LLC; Optiver US LLC; RGM Advisors, LLC; Templar Securities, LLC; Tower Research Capital LLC; TradeForecaster Global Markets LLC; Traditum Group, LLC; WH Trading LLC; XR Trading LLC ("Trading Firms"); Managed Funds Association ("MFA"); Arbor Research & Trading Inc. ("Arbor"); Eris Exchange ("Eris"); ICI; DRW Trading Group ("DRW"); Spring Trading, Inc. ("Spring Trading"); Javelin Capital Markets, LLC ("Javelin"); The Committee on Investment of Employee Benefit Assets ("CIEBA"); Citadel LLC ("Citadel"); Vizier Ltd. ("Vizier"); Federal Home Loan Banks ("FHLB"); Jefferies & Company, Inc. ("Jeffries"); UBS Securities LLC ("UBS"); Wells Fargo Securities ("WF"); LCH.Clearnet Group Limited ("LCH"); D. E. Shaw group ("D. E. Shaw"); Bank of America, Merrill Lynch, BNP Paribas, Citi, Credit Suisse Securities (USA) LLC, Deutsche Bank AG,

rules.[16] They included asset managers, market makers, trading platforms, clearing organizations, bank/dealers, a non-profit organization, and a private citizen. Within this group, some commenters addressed only certain aspects of the rules and were silent on other sections and some requested clarification of certain provisions.

Eight commenters expressed opposition.[17] They include bank/dealers, an association of electric utilities, and an asset manager. Within this group as well, some commenters addressed only certain aspects of the rules and were silent on other sections and some requested clarification of certain provisions.

Three commenters in support—Arbor, Citadel, and Eris—urged the Commission to make these rules a top priority in the final rulemaking process. Numerous commenters stated that the proposed rules would increase open access to clearing and execution, reduce risk, foster competition, lower costs, and increase transparency. FHLB expressed the view that the proposed rules will facilitate the transition to central clearing. Barnard and Vanguard asserted that the proposed rules will prevent conflicts of interest, and achieve clear walls between clearing and trading activities involving FCMs and affiliates. Six commenters went into detail why the trilateral agreements are bad for the markets, noting that such agreements discourage competition and efficient pricing, compromise anonymity, reduce liquidity, increase the time between execution and clearing, introduce conflicts of interest, and prevent the success of swap execution facilities ("SEFs").[18] SDMA commented that while "the SDMA is philosophically loathe to encourage

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Goldman Sachs, HSBC, J.P. Morgan, Morgan Stanley ("Banks"); Deutsche Bank ("DB"); Societe Generale ("SG"); The Association of Institutional Investors ("AII"); and The Committee on Capital Markets Regulation ("Committee").

[16] AII, AIMA, AllianceBernstein, Arbor, Better Markets, Barnard, CIEBA, Citadel, CME, D. E. Shaw, DRW, Eris, FHLB, ICE, ICI, Javelin, Jeffries, LCH, Markit, MFA, MGEX, NYPC, SDMA, SIFMA, Spring Trading, State Street, Trading Firms, Vanguard, Vizier, and WF.

[17] DB, ISDA, SG, UBS, Morgan Stanley, the Banks, EEI, and the Committee.

[18] AIMA, Javelin, SG, SIFMA, Spring Trading, and Vanguard.

possible government [interference] with private contracts between two parties," the proposed rules are necessary in their entirety in this instance, and that the proposed rules are not overly prescriptive. Vanguard, estimated that if it was required to enter into trilateral agreements, it would have to negotiate approximately 4,800 new trilateral agreements per year.[19]

Seven commenters in opposition contended that without the trilateral agreements, some market participants may have reduced access to markets.[20] (ISDA and the Committee did not address this issue.) They asserted that the trilateral agreements facilitate risk management and certainty of execution. DB believes that the trilateral agreements provide a means of ensuring compliance with mandatory clearing. DB also commented that if an SD does not know whether a swap will be cleared prior to execution, it will not know whether it should apply risk filters that take account of the swap as a cleared transaction or a bilateral one. SG commented that the rules will decrease liquidity and limit market participation, and that without the certainty of trilateral agreements, the rules may foster competing and inconsistent technology.

UBS believes that potential abuse of credit arrangements could be more narrowly tailored than the proposed rule. The Banks asserted that the credit filter infrastructure necessary to maximize execution choice for customers while ensuring prudent risk management is not currently available. The Banks suggested that instead of prohibiting the trilateral agreements, the Commission could require that the allocation of credit limits across executing counterparties be specified by the customer, rather than the FCM, who would confirm the customer's allocation to the identified executing counterparties.

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[19] Vanguard.
[20] Banks, DB, EEI, ISDA, Morgan Stanley, SG, and UBS.

Morgan Stanley requested clarification that the proposed rules only apply to arrangements between clearing firms and executing swap dealers and customers with respect to swaps, not futures. Morgan Stanley also commented that the Commission should alter the language in proposed § 1.72 and § 23.608 from "relationship to the best terms available" to "execution with an executing swap dealer of the customer's choice."

Spring Trading requested clarification that "on terms that have a reasonable relationship to the best terms available" refers to the best terms available on any market regulated by the Commission, which would prohibit an FCM from establishing special hurdles for its clearing customers in order to trade on a particular SEF.

C. Discussion

The Commission found persuasive the comments stating that the proposed rules would increase open access to clearing and execution, reduce risk, foster competition, lower costs, and increase transparency. The Commmission notes that cleared futures markets have operated for decades without any need for the types of provisions prohibited by the rules. Similarly, trades executed over-the-counter ("OTC") have been successfully cleared by CME and ICE on behalf of customers for approximately ten years without such provisions.

Specifically, the Commission believes that, as discussed by numerous commenters, (1) disclosure of a customer's original executing counterparty could have potentially anticompetitive effects, (2) limiting the number of counterparties would hurt the customer's access to the best price as well as general market liquidity, (3) restricting the size of trades with particular counterparties also would hurt the customer's access to the best price as well as general market liquidity, and (4) restrictions on the number of

counterparties and on the size of trades with them would slow down acceptance for clearing thereby causing the very problem the restrictions were purportedly designed to address.

The Commission believes that the risks the trilateral agreements were designed to address can be mitigated by other means without incurring the negative consequences described above. Specifically, the processing rules described in section III. below and the risk management rules described in section IV. below would significantly diminish the exposure of dealers, their counterparties, and their respective FCMs to risk.

Moreover, the Commission notes that there are several sections of the CEA and Commission regulations that support the premise underlying these final rules. Section 4d(c) of the CEA, as amended by the Dodd-Frank Act, directs the Commission to require FCMs to implement conflict of interest procedures that address such issues the Commission determines to be appropriate. Similarly, section 4s(j)(5), as added by the Dodd-Frank Act, requires SDs and MSPs to implement conflict of interest procedures that address such issues the Commission determines to be appropriate. Section 4s(j)(5) also requires SDs and MSPs to ensure that any persons providing clearing activities or making determinations as to accepting clearing customers are separated by appropriate informational partitions from persons whose involvement in pricing, trading, or clearing activities might bias their judgment or contravene the core principle of open access.

Pursuant to these provisions, the Commission promulgated § 1.71(d) relating to FCMs and § 23.605(d) relating to SDs and MSPs.[21] These regulations prohibit SDs and

[21] "Swap Dealer and Major Swap Participant Recordkeeping and Reporting, Duties, and Conflicts of Interest Policies and Procedures; Futures Commission Merchant and Introducing Broker Conflicts of Interest Policies and Procedures; Swap Dealer, Major Swap Participant, and Futures Commission Merchant Chief Compliance Officer," available at

MSPs from interfering or attempting to influence the decisions of affiliated FCMs with regard to the provision of clearing services and activities, and prohibit FCMs from permitting them to do so.

Section 4s(j)(6) of the CEA prohibits an SD or MSP from adopting any process or taking any action that results in any unreasonable restraint on trade or imposes any material anticompetitive burden on trading or clearing, unless necessary or appropriate to achieve the purposes of the Act. To implement Section 4s(j)(6) of the CEA, the Commission has promulgated § 23.607 in a separate rulemaking.[22]

Section 2(h)(1)(B)(ii) of the CEA requires that DCO rules provide for the non-discriminatory clearing of swaps executed bilaterally or through an unaffiliated designated contract market ("DCM") or SEF. The Commission has adopted § 39.12(b)(3) to implement this provision.[23]

The trilateral agreements potentially conflict with the recently-adopted §§ 1.71(d), 23.605(d), 23.607, and 39.12. As certain commenters have stated, the provisions of the trilateral agreements described above could lead to undue influence by FCMs on a customer's choice of counterparties or undue influence by SDs on a customer's choice of clearing member. They could constrain a customer's opportunity to obtain competitive execution of the trade by limiting the number of potential counterparties.

The documentation rules covered by this rulemaking are consistent with, and complementary to, the recently adopted rules. The rules in this Federal Register release address specific circumstances that have been identified to the Commission by market

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http://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/DF_4_BusConductStandardsInternal/ssLINK/federalregister022312b.

[22] Id.

[23] 76 FR 69334, Nov. 8, 2011.

participants, while the previously adopted rules set forth more general principles. The Commission believes that, in this case, market participants and the general public would be best served by providing both the clarity of a bright-line test for certain identifiable situations and the guidance of more broadly-articulated principles.

Contrary to the assertion of some commenters, the rules do not prohibit trilateral agreements; they prohibit certain provisions whether contained in a trilateral or a bilateral agreement. The rules have been tailored to address specific issues identified by market participants.

The Commission emphasizes that nothing in these rules would restrain an SD or MSP from establishing bilateral limits with each of its counterparties. Further, nothing in these rules would impair an SD's or MSP's ability to conduct due diligence with regard to each of its counterparties, including evaluation of balance sheet, credit ratings, overall market exposure, or similar factors.

The Commission is revising the language in §§ 23.608 and 23.608(c) to clarify that, for swaps that will be submitted for clearing, an SD or MSP may continue to manage its risk by limiting its exposure to the counterparty with whom it is trading. This clarification is intended to emphasize that SDs and MSPs may continue to conduct appropriate risk management exercises. Moreover, the Commission believes that this modification is responsive to the concern raised by some commenters that until straight through processing is achieved, SDs and MSPs will still need to manage risk to a counterparty before a trade is accepted or rejected for clearing.[24] Furthermore, the Commission also believes that § 23.608 does not preclude an SD or MSP from requiring

[24] ISDA.

that a counterparty confirm that the counterparty has an account with an FCM through which the counterparty will clear.

In response to the Morgan Stanley request for clarification, the Commission confirms that the rules, as drafted, only apply to swaps. As noted, similar provisions have never been needed and, therefore, were not proposed for futures.

The Commission has determined not to modify the language in §§ 1.72 and 23.608 as suggested by Morgan Stanley from "relationship to the best terms available" to "execution with an executing swap dealer of the customer's choice." The rule should not imply that customers may only trade with swap dealers. Moreover, some swap markets operate anonymous central limit order books. In these instances, the counterparty is immaterial; trading decisions are based on solely the terms of the trade.

The Commission also has determined not to adopt the clarification suggested by Spring Trading. Requiring execution on the best terms available on any market regulated by the Commission could impose burdensome search costs.[25] Moreover, there could be operational costs in establishing connectivity to every market. It is not clear how many markets there will be or how compatible their systems will be with one another or with the systems of all FCMs and SDs. Upon review of the comments, the Commission is adopting §§ 1.72, and 39.12(a)(1)(vi) as proposed, and § 23.608 with the modification described above.

III. Time Frames for Acceptance into Clearing

A. Swap Dealer and Major Swap Participant Submission of Trades

1. Introduction

[25] The Commission notes that this rule does not impose a best execution requirement. This rule merely prohibits a contractual provision that would impair a customer's access to execution of a trade on terms that have a reasonable relationship to the best terms available.

Section 731 of the Dodd-Frank Act amended the CEA by adding a new section 4s, which sets forth a number of requirements for SDs and MSPs. Specifically, section 4s(i) of the CEA establishes swap documentation standards for those registrants. Section 4s(i) requires SDs and MSPs to "conform with such standards as may be prescribed by the Commission by rule or regulation that relate to timely and accurate confirmation, processing, netting, documentation, and valuation of all swaps." Section 8a(5) of the CEA authorizes the Commission to promulgate such regulations as, in the judgment of the Commission, are reasonably necessary to effectuate any of the provisions or to accomplish any of the purposes of the Act.[26] Pursuant to these provisions, and in order to ensure compliance with any mandatory clearing requirement issued pursuant to section 2(h)(1) of the CEA and to promote the mitigation of counterparty credit risk through the use of central clearing, the Commission proposed § 23.506.

As proposed, § 23.506(a)(1) would require that SDs and MSPs have the ability to route swaps that are not executed on a SEF or DCM to a DCO in a manner that is acceptable to the DCO for the purposes of risk management. Under § 23.506(a)(2), as proposed, SDs and MSPs would also be required to coordinate with DCOs to facilitate prompt and efficient processing in accordance with proposed regulations related to the timing of clearing by DCOs.

As proposed, § 23.506(b) would set forth timing requirements for submitting swaps to DCOs in those instances where the swap is subject to a clearing mandate and in those instances when a swap is not subject to a mandate. Under § 23.506(b)(1), as proposed, an SD or MSP would be required to submit a swap that is not executed on a SEF or DCM,

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[26] 7 U.S.C. 12a(5).

but is subject to a clearing mandate under section 2(h)(1) of the CEA (and has not been electively excepted from mandatory clearing by an end user under section 2(h)(7) of the CEA) as soon as technologically practicable following execution of the swap, but no later than the close of business on the day of execution.[27]

For those swaps that are not subject to a clearing mandate, but for which both counterparties to the swap have elected to clear the swap, under § 23.506(b)(2), as proposed, the SD or MSP would be required to 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. This time frame reflects the possibility that in the case of a bilateral swap, the parties may need time to agree to terms that would conform with a DCO's requirements for swaps it will accept for clearing. As noted previously, any delay between execution and novation to a clearinghouse potentially presents credit risk to the swap counterparties and the DCO because the value of the position may change significantly between the time of execution and the time of novation, thereby allowing financial exposure to accumulate in the absence of daily mark-to-market. The proposed regulation was designed to limit this delay as much as reasonably possible.

2. Summary of Comments

MFA generally supported proposed §§ 23.506(a) and 23.506(b).

CME commented that the regulations should not require any particular system or methodology that SDs or MSPs must use for submitting swaps to DCOs. Instead, the regulations should give each DCO the flexibility to work with SDs and MSPs to

[27] The Commission notes that it is not expressing an opinion at this time as to whether a mandatory clearing determination must be made in conjunction with a mandatory trading determination.

implement various systems and methodologies for swap submission, which may be subject to change over time as cleared swap markets continue to develop and grow.

ISDA also indicated that the rule should permit SDs and MSPs, coordinating with their DCOs, to be free to select the manner by which they route their swaps to DCOs. ISDA, however, commented that it is not apparent what proposed § 23.506(a) adds to the § 39.12(a)(3) requirement that clearing members have adequate operational capacity to meet obligations arising from their participation in DCOs. ISDA also noted that market participants have for some time been developing industry standards for the prompt and efficient processing of cleared swap transactions, and it suggested that the Commission study these standards and defer to them wherever possible.

MarkitSERV commented that the requirement to submit swaps "as soon as technologically practicable following execution" may be inappropriate in light of the Commission's proposed rule regarding confirmation requirements, which requires that swap transactions be confirmed within a certain time period after execution. MarkitSERV suggested that the regulation reference the time of confirmation as opposed to the time of execution. MarkitSERV also noted that requiring SDs and MSPs to submit swaps for clearing "no later than the close of business on the day of execution" fails to accommodate transactions that occur late in the day and suggested a 24 hour time period.

MarkitSERV also commented that there are numerous benefits to using third party middleware providers for routing and processing services, and it suggested that the Commission permit swap counterparties to control how they process transactions. According to MarkitSERV, counterparties should be permitted to use independent third party providers for confirming, routing, and satisfying the portfolio reconciliation

requirements proposed by the Commission. MarkitSERV also suggested that the Commission clarify how proposed § 23.506 would interact with proposed § 23.501, which requires confirmation of all swaps, and with the then-proposed rules requiring reporting of swap transactions to an SDR.[28]

FIA commented that SDs and MSPs are unlikely to submit a swap directly to a DCO for clearing. Instead, they will first affirm the swap by, for example, submitting the relevant details to an affirmation platform and then submit the swap to their respective clearing members for submission to a DCO.

FIA suggested that the Commission should require SDs and MSPs to have a clearing arrangement in place with clearing members that, in turn, have the capacity to route orders to a DCO in a manner acceptable to it.

FIA also believes that the "no later than close of business" could not be satisfied by swaps that are entered into later in the day and suggests the proposed rule be revised to provide the parties greater flexibility to submit a swap for clearing within a reasonable time as prescribed by the applicable DCO. Finally, to encourage the voluntary use of clearing where such swaps are not required to be cleared, FIA suggests that the proposed § 23.506(b)(2) 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.

The Options Clearing Corporation ("OCC") commented that the phrase "for purpose of risk management" in proposed §§ 23.506(a)(1) and 37.702(b)(1) creates ambiguity because a DCO may have established routing requirements for reasons unrelated to risk management such as increased efficiency or decreased administrative costs. OCC

[28] Swap Data Repositories: Registration Standards, Duties and Core Principles, 76 FR 54538 (Oct. 31, 2011).

believes that a party that submits transactions to a DCO for clearing should be required to ensure that it has the ability to route the transactions to the DCO in a manner that meets all of the DCO's legitimate requirements, and not only those that are related to risk management. OCC suggests that the Commission delete the phrase "for purpose of risk management" and substitute the phrase "for clearing."

SDMA supported the amendments to proposed § 23.506, and suggested that the Commission promulgate rules that ensure post-trade and pre-trade integrity. According to SDMA, the buyer and seller must know immediately whether their trade has been accepted for clearing. Trade uncertainty, SDMA continued, caused by the time delay between the time of trade execution and the time of trade acceptance into clearing, undermines market integrity in the post-trade work process. SDMA also stated that trade uncertainty also directly impedes liquidity, efficiency, and market stability.

CME commented that the technology for SDs and MSPs to route swaps to a DCO may be as simple as entering the necessary data in a web page. It suggested that a more apt standard may be "as soon as operationally feasible." CME also believes that the proposed time frames for submission of swaps are appropriate and operationally feasible, and it is not aware of systemic obstacles to the coordination between DCOs, MSPs, and SDs required under the proposed regulation.

FHLBanks commented that the time frames are appropriate provided that the Commission establishes a cut-off time for determining the day on which a swap is executed because it may not be "technologically practicable" for a swap that is executed towards the end of a day to be submitted for clearing that day. FHLBanks suggests the

rule specify that swaps executed after 4 p.m. New York time shall be deemed to be executed on the following business day.

ISDA commented that submission by the close of business may not be technologically practicable. In addition, ISDA suggested that trades will need to go through an affirmation platform and clearing members will need to screen trades for compliance with their own standards and with DCO standards, and this may not occur before the end of the business day. ISDA also expressed concern that mandatory, same day submission may invite error because clearing members may focus on speed over accuracy. ISDA suggested that the Commission impose an "as soon as reasonably and technologically practicable" standard.

ISDA also commented that § 23.506(b)(2) should not set forth a time period for clearing. According to ISDA, limiting the flexibility of parties voluntarily seeking to clear will only create disincentives to such voluntarism, including confusion and potential legal uncertainty. Thus, ISDA suggested that where parties voluntarily elect to submit a swap for clearing, all aspects of that election should be left to the parties to determine contractually.

Freddie Mac commented that swap dealers periodically enter mismatched data and send swap confirmations that incorrectly reflect the principal terms of transactions. As a result, Freddie Mac believes that a standard for submitting clearing submissions that starts the clock at execution would be confusing and impractical and it could be detrimental to counterparties who are subject to undue pressure to quickly assent to terms dictated by a market professional. Freddie Mac also commented that establishing a close of business deadline for submission of swaps for clearing would impair late day trading

and potentially reduce market integrity. Freddie Mac suggested that the Commission modify proposed § 23.506(b)(1) to provide that SDs and MSPs are required to submit swaps that are not executed on a SEF or DCM but that are subject to a clearing mandate as soon as commercially and operationally practical for both parties but no later than 24 hours after execution.

LCH commented that swaps not subject to mandatory clearing obligations should not be subject to any timeline. LCH believes that a DCO should be able to accept such trades whenever they are submitted, provided that it has sufficient margin from both sides.

3. Discussion

Proposed § 23.506(a) does not prescribe the manner by which SDs or MSPs route their swaps to DCOs and provide for prompt and efficient processing. It is possible that DCOs will enable SDs and MSPs to submit their swaps to clearing via third-party platforms and other service providers. DCOs will certainly specify the role of their clearing members in the process.

The flexibility of the rule makes it consistent with the comments of MFA, CME, ISDA, MarkitSERV, and FIA. The Commission concurs with OCC's comment that a DCO may have requirements beyond risk management. The issue raised by SDMA is addressed in the customer documentation provisions.

As discussed above, any delay between the time of execution and the time of clearing creates financial risk for the parties to the trade and for their clearing FCMs. For trades that are not subject to a clearing mandate, the parties are not bound by any submission deadlines unless and until they voluntarily agree to have the trade cleared. Once they make that decision, however, it will reduce risk for both the parties, as well as their

respective clearing members, to get the trade submitted for clearing as soon as practicable. Therefore, in most cases it seems likely that the parties will comply with the timing set forth within the rule because it is in their own best interests to do so. But, to leave "all aspects" to the parties, as ISDA suggested, creates the possibility that one party could expose itself, its counterparty, and its clearing member to unnecessary risk by delaying submission.[29] In light of all the comments, the Commission believes that the timeframes for submission set forth in the proposed rules are reasonable.

The Commission is not defining "business day" in this rule, in order to allow the entity accepting the trade for clearing, the DCO, to establish its own definition. The Commission understands that a DCO may choose to expand its business hours in order to offer a competitive advantage, and that this rule should not prescribe when swaps may be accepted for clearing. The Commission further believes that if a trade is submitted for clearing near the end of a business day for a particular DCO, but is ultimately not accepted or rejected before that deadline, the DCO will determine whether the trade will be accepted or rejected for clearing for the following day in accordance with § 39.12.

The Commission is adopting § 23.506(a)(1) with the amendment suggested by OCC, changing "for purposes of risk management" to "for purposes of clearing."

The Commission is adopting §§ 23.506(a)(2) and 23.506(b) as proposed.

B. Swap Execution Facility and Designated Contract Market Processing of Trades

1. Introduction

For prompt and efficient clearing to occur, the rules, procedures, and operational systems of the trading platform and the clearinghouse must align. Vertically integrated trading and clearing systems currently process high volumes of transactions quickly and

[29] See ISDA.

efficiently. The Commission believes that trading platforms and DCOs under separate control should be able to coordinate with one another to achieve similar results.

The Commission proposed §§ 37.700 through 37.703 to implement SEF Core Principle 7 (Financial Integrity of Transactions), pursuant to its rulemaking authority under sections 5h(h) and 8a(5) of the CEA.[30] Core Principle 7 requires a SEF to "establish and enforce rules and procedures for ensuring the financial integrity of swaps entered on or through the facilities of the swap execution facility, including the clearing and settlement of the swaps pursuant to section 2(h)(1) [of the CEA]."[31] As originally proposed, § 37.702(b) would require a SEF to provide for the financial integrity of its transactions cleared by a DCO by ensuring that the SEF has the capacity to route transactions to the DCO in a manner acceptable to the DCO for purposes of risk management.[32] As part of the processing rulemaking, the Commission proposed to renumber previous § 37.702(b) as paragraph (b)(1) and add a new paragraph (b)(2) to require the SEF to additionally provide for the financial integrity of cleared transactions by coordinating with each DCO to which it submits transactions for clearing, in the development of rules and procedures to facilitate prompt and efficient transaction processing in accordance with the requirements of § 39.12(b)(7) of the Commission's regulations.[33]

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[30] See Core Principles and Other Requirements for Swap Execution Facilities, 76 FR 1214 (Jan. 7, 2011); 7 U.S.C. 7b-3(h); and 7.U.S.C. 12a(5).

[31] See section 5h(f)(7) of the CEA, 7 U.S.C. 7b-3(f)(7).

[32] See 76 FR at 1248. Section 37.702(b), as originally proposed, referred to "ongoing" risk management. In renumbering and finalizing this provision herein, the Commission is deleting the term "ongoing" because it is superfluous and could create confusion when read in conjunction with other Commission regulations that refer to "risk management." See, e.g., proposed § 39.13 relating to risk management for DCOs, 76 FR at 3720.

[33] See 76 FR 13101 (Mar. 10, 2011) (setting forth time frames for accepting or rejecting swaps for clearing).

Similarly, the Commission previously proposed §§ 38.600 through 38.607 to implement DCM Core Principle 11 (Financial Integrity of Transactions) pursuant to its rulemaking authority under sections 5(d)(1) and 8a(5) of the CEA.[34] Core Principle 11 requires a DCM to "establish and enforce–(A) rules and procedures for ensuring the financial integrity of transactions entered into on or through the facilities of the contract market (including the clearance and settlement of the transactions with a derivatives clearing organization); and (B) rules to ensure—(i) the financial integrity of any—(I) futures commission merchant; and (II) introducing broker; and (ii) the protection of customer funds."[35]

As originally proposed, § 38.601 would require that transactions executed on or through a DCM, other than transactions in security futures products, must be cleared through a registered DCO in accordance with the provisions of part 39 of the Commission's regulations.[36] The Commission later proposed to renumber this provision as paragraph (a) of proposed § 38.601 and add a new paragraph (b) to specifically require the DCM to coordinate with each DCO to which it submits transactions for clearing, in the development of DCO rules and procedures to facilitate prompt and efficient transaction processing in accordance with the requirements of § 39.12(b)(7) of the Commission's regulations.[37]

2. Summary of Comments

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[34] See Core Principles and Other Requirements for Designated Contract Markets, 75 FR 80572 (Dec. 22, 2010); 7 U.S.C. 7(d)(1); and 7.U.S.C. 12a(5).

[35] See Section 5(d)(11) of the CEA, 7 U.S.C. 7(d)(11).

[36] See 75 FR at 80618.

[37] See 76 FR 13101.

FIA supported the rules and recommended that each SEF and DCM be required to assure equal access to all DCOs that wish to clear trades executed through the facilities of the SEF or DCM. According to FIA, failure to grant such access would be inconsistent with section 2(h) of the CEA as amended by the Dodd-Frank Act, which (1) provides for the non-discriminatory clearing of swaps executed bilaterally or on an unaffiliated SEF or DCM, and (2) provides that, with respect to a swap that is entered into by a SD or MSP, the counterparty shall have the sole right to select the DCO through which the swap is cleared.

LCH also concurred with both rules. It commented that it is of paramount importance that: (1) a SEF or DCM seeking access to a DCO must first be required to meet all regulatory requirements; (2) each SEF and DCM must code to each DCO's application programming interfaces; and (3) each SEF and DCM must treat DCOs on a nondiscriminatory basis.

ISDA commented that coordination among the parties subject to the Commission's new swap jurisdiction is critical to ensuring that the rulemaking process is effective without disrupting the swap markets and applauds this proposal. ISDA suggested that an existing standard managed by ISDA and used between participating companies be adopted.

As noted above, OCC commented that the phrase "for purpose of risk management" in proposed §§ 23.506(a)(1) and 37.702(b)(1) creates ambiguity because a DCO may have established routing requirements for reasons unrelated to risk management such as increased efficiency or decreased administrative costs. OCC believes that a party that submits transactions to a DCO for clearing should be required to ensure that it has the

ability to route the transactions to the DCO in a manner that meets all of the DCO's legitimate requirements, and not only those that are related to risk management. OCC suggests that the Commission delete the phrase "for purpose of risk management" and substitute the phrase "for clearing."

3. Discussion

Rules, procedures, and operational systems, along the lines set forth in the rules, currently work well for many exchange-traded futures. Similar requirements could be applied across multiple exchanges and clearinghouses for swaps. The parties would need to have clearing arrangements in place with clearing members in advance of execution. In cases where more than one DCO offered clearing services, the parties also would need to specify in advance where the trade should be sent for clearing.

The Commission concurs with OCC's comment that a DCO may have requirements beyond risk management. To the extent that FIA, LCH, and ISDA recommended that the Commission adopt additional requirements beyond those set forth in the rule as proposed, the Commission believes it is premature to adopt the additional requirements at the present time. However, the Commission will monitor the implementation of this rule and may propose amendments in the future.

The Commission is adopting § 38.601 as proposed. The Commission is adopting § 37.702 with the amendment suggested by OCC changing "for purposes of risk management" to "for purposes of clearing."

C. Clearing Member and Clearing Organization Acceptance for Clearing

1. Introduction

As noted above, a goal of the Dodd-Frank Act is to reduce risk by increasing the use of central clearing. Minimizing the time between trade execution and acceptance into clearing is an important risk mitigant.

This time lag potentially presents credit risk to the swap counterparties, clearing members, and the DCO because the value of a position may change significantly between the time of execution and the time of novation, thereby allowing financial exposure to accumulate in the absence of daily mark-to-market. Among the purposes of clearing are the reduction of risk and the enhancement of financial certainty, and this time lag diminishes the benefits of clearing swaps that Congress sought to promote in the Dodd-Frank Act. A delay in clearing is also inconsistent with other proposed regulations concerning product eligibility and financial integrity of transactions insofar as the delay reduces liquidity and increases risk.[38]

In this rulemaking, the Commission is seeking to expand access to, and strengthen the financial integrity of, the swap markets subject to Commission oversight by providing for prompt processing, submission, and acceptance of swaps eligible for clearing by DCOs. This requires setting an appropriate time frame for the processing and submission of swaps for clearing, as well as a time frame for the clearing of swaps by the DCO.

As originally proposed, § 39.12(b)(7)(i) required DCOs to coordinate with DCMs and SEFs to facilitate prompt and efficient processing of trades. In response to a comment, the Commission later proposed to require "prompt, efficient, <u>and accurate</u> processing of trades."[39]

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[38] <u>See</u> 76 FR 1214, Jan. 7, 2011.
[39] <u>See</u> letter from Robert Pickel, Executive Vice Chairman, International Swaps and Derivatives Association, dated April 8, 2011.

Recognizing the key role clearing members play in trade processing and submission of trades to central clearing, the Commission also proposed parallel provisions for coordination among DCOs and clearing members. Proposed § 39.12(b)(7)(i)(B) would require DCOs to coordinate with clearing members to establish systems for prompt processing of trades. Proposed §§ 1.74(a) and 23.610(a) would require reciprocal coordination with DCOs by FCMs, SDs, and MSPs that are clearing members.

As originally proposed, § 39.12(b)(7)(ii) required DCOs to accept immediately upon execution all transactions executed on a DCM or SEF.[40] A number of DCOs and other commenters expressed concern that this requirement could expose DCOs to unwarranted risk because DCOs need to be able to screen trades for compliance with applicable clearinghouse rules related to product and credit filters.[41] The Commission recognized that while immediate acceptance for clearing upon execution currently occurs in some futures markets, it might not be feasible for all cleared markets at this time. For example, where the same cleared product is traded on multiple execution venues, a DCO needs to be able to aggregate the risk of trades coming in to ensure that a clearing member or customer has not exceeded its credit limits. Accordingly, the Commission modified proposed § 39.12(b)(7)(ii) to permit DCOs to screen trades against applicable product and credit criteria before accepting or rejecting them.[42] Consistent with principles of

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[40] See Requirements for Processing, Clearing, and Transfer of Customer Positions, 76 FR 13101 (March 10, 2011).

[41] See letter from Craig S. Donohue, Chief Executive Officer, CME Group, dated April 11, 2011; letter from R. Trabue Bland, Vice President and Assistant General Counsel, ICE, dated April, 11, 2011; letter from Iona J. Levine, Group General Counsel and Managing Director, LCH.Clearnet, dated April, 11, 2011; letter from William H. Navin, Executive Vice President and General Counsel , Options Clearing Corporation, dated April, 11, 2011; letter from John M. Damgard, President, Futures Industry Association, dated April 14, 2011.

[42] See 76 FR 45730, Aug. 1, 2011.

open access, the proposal would require that such criteria be non-discriminatory with respect to trading venues and clearing participants.

Proposed § 1.74(b) would set up a parallel requirement for clearing FCMs; proposed § 23.610(b) would set up a parallel requirement for SDs and MSPs that are clearing members. These rules, again, would apply a performance standard, not a prescribed method for achieving it.

As originally proposed, §§ 39.12(b)(7)(iii) and 39.12(b)(7)(iv) distinguished between swaps subject to mandatory clearing and swaps not subject to mandatory clearing.[43] Upon review of the comments, the Commission concluded that this distinction was unnecessary with regard to processing time frames. If a DCO lists a product for clearing, it should be able to process it regardless of whether clearing is mandatory or voluntary. Accordingly, the Commission modified proposed § 39.12(b)(7)(iii) to cover all trades not executed on a DCM or SEF. It would require acceptance or rejection by the DCO as quickly after submission as would be technologically practicable if fully automated systems were used.

Proposed § 1.74(b) would set up a parallel requirement for clearing FCMs; proposed § 23.610(b) would set up a parallel requirement for SDs and MSPs that are clearing members. These rules, again, would apply a performance standard, not a prescribed method for achieving it.

The Commission also recognized that some trades on a DCM or SEF may be executed non-competitively. Examples include block trades and exchanges of futures for physicals ("EFPs"). A DCO may not be notified immediately upon execution of these

[43] See 76 FR 13101, Mar. 10, 2011.

trades. Accordingly, the proposal treated these trades in the same manner as trades that are not executed on a DCM or SEF.

2. Summary of Comments

Eighteen[44] commenters expressed support for the timing standard as proposed by the Commission.

CME recommended that the standard be revised to "as quickly as would be technologically practicable if fully automated systems and filters were used or as quickly as possible if automated systems or filters are not used."

MGEX requested that the Commission codify the preamble text that the new timing standard would require action in a matter of "milliseconds or seconds or, at most, a few minutes, not hours or days." MGEX also commented that proposed § 39.12(b)(7) should be a general acceptance and timing rule, not applicable for each specific contract listed to be cleared. MGEX argued that the rule only should apply to those swaps that a DCO has identified that it can and will clear, as opposed to variations of contracts listed for clearing or any contract not previously cleared by the DCO.

Morgan Stanley believes that the timing standard should be intended to prohibit only those arrangements that prevent the use of automated systems that are available in the market to facilitate clearing.

LCH suggested that the Commission modify proposed §§ 39.12(7)(ii) and (iii) by adding the language "and for which sufficient margins have been received by the derivatives clearing organization" prior to accepting and confirming a trade for clearing.

[44] AIMA, AllianceBernstein, Arbor, Barnard, CIEBA, Citadel, DRW, Eris, FHLB, ICI, Javelin, Jeffries, MFA, SDMA, State Street, Spring Trading, Trading Firms, and Vizier.

NYPC requested clarification that in circumstances where a DCO automatically receives matched trade data from a DCM or SEF on a locked-in basis, no further systems development would be required in order to satisfy the above-referenced requirements of proposed regulations 1.74(a) and 39.12(b)(7)(i)(B).

Better Markets stated that the timing standard must be: (1) provided by the DCO or FCM; (2) capable of receiving and processing trade data from multiple sources in real time; (3) able to screen against standards such as price levels and block trade sizes as a threshold matter; (4) able to decrease or increase available credit real time; and (5) automatic push notification of acceptance or rejection by the DCO or FCM. Better Markets also commented that systems provided by a DCO or FCM must be open and require no special capabilities on the part of the trade execution venue, and that once data is input, the systems must function on a first-come-first-served basis using a reliable and common time stamping regime, regardless of affiliation or contractual relationship between the trading venue and DCO or FCM. Better Markets noted that confirmation of acceptance or rejection must not differ between trading venues based on affiliation or relationship.

SG suggested that the Commission establish one or both of the following: (1) credit limits of customers and FCMs are stored at the DCO and provided to SEFs in real time upon electronic demand; or (2) an industry-wide utility that stores customer and FCM limits and provides them to DCOs and SEFs in real time upon electronic demand.

3. Discussion

The Commission continues to believe that acceptance or rejection for clearing in close to real time is crucial both for effective risk management and for the efficient

operation of trading venues.[45] Rather than prescribe a specific length of time, the Commission is implementing a standard that action be taken "as quickly as would be technologically practicable if fully automated systems were used." This standard would require action in a matter of milliseconds or seconds or, at most, a few minutes, not hours or days. The Commission recognizes that processing times may vary by product or market.

This requirement is intended to be a performance standard, not the prescription of a particular method of trade processing. The Commission expects that fully automated systems will be in place at some DCOs, FCMs, SDs, and MSPs. Others might have systems with some manual steps. The use of manual steps would be permitted so long as the process could operate within the same time frame as the automated systems.

As discussed by numerous commenters, the proposed standard approximates real-time acceptance while providing flexibility to accommodate different systems and procedures. Avoiding a large gap between trade execution and acceptance for clearing is crucial to risk management for DCOs, FCMs, and market participants.

The Commission notes that the time frame for acceptance by clearing members and DCOs set forth in this section is stricter than the time frames for submission by SDs and MSPs set forth in Section III.A., above. Where execution is bilateral and clearing is voluntary, the delay between execution and submission to clearing is, of necessity, within the discretion of the parties to some degree. The Commission believes, however, that prudent risk management dictates that once a trade has been submitted to a clearing member or a DCO, the clearing member or DCO must accept or reject it as quickly as possible.

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[45] See letter from James Cawley, Swaps and Derivatives Market Association, dated April 19, 2011.

Assuring prompt acceptance or rejection for clearing also undermines much of the stated rationale for the provisions in the trilateral agreements. In those unusual circumstances in which trades are rejected, the parties will know almost immediately and be able to take appropriate steps to mitigate risk.

The Commission disagrees with CME's suggested standard of "as quickly as possible." The Commission believes that this standard would introduce too much potential for delay. It could increase the very risks that this final rulemaking is designed to reduce or eliminate.

In support of the final standard, the Commission notes that on December 13, 2011, $4.1 billion of trades were executed on a trading platform and cleared by a DCO within the time frame contemplated by the proposed rules. Specifically, 21 interest rate swaps were executed and cleared with an average time of 1.9 seconds and a quickest time of 1.3 seconds.[46]

The Commission also disagrees with the MGEX suggestion that the timing standard should be codified as "milliseconds, seconds, or minutes," because this would provide a window for trade acceptance that might be too wide as faster systems become available. The Commission believes that its proposed standard will allow for innovation to bring faster trade acceptance or rejection to the market most efficiently.

The Commission also disagrees with LCH's proposed addition of the language "and for which sufficient margins have been received by the derivatives clearing organization" prior to accepting and confirming a trade for clearing. This standard may not be

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[46] Katy Burne, UPDATE: Javelin, CME Claim Record Time To Clear Rate Swaps, Dow Jones Newswires, Nasdaq (Dec. 14, 2011; accessed Jan. 3, 2012) http://www.nasdaq.com/aspx/stock-market-news-story.aspx?storyid=201112141726dowjonesdjonline000739&title=updatejavelincme-claim-record-time-to-clear-rate-swaps.

practicable for DCOs that are linked to high-volume automated trading systems. Currently, many DCOs in such circumstances calculate margin at the end of the day for collection the next day. Nothing in the final rules, however, precludes a DCO in its discretion from applying such a standard.

The Commission confirms NYPC's belief that in circumstances where a DCO automatically receives matched trade data from a DCM or SEF on a locked-in basis, no further systems development would be required.

The Commission believes that the comments of Better Markets and SG are consistent with the intent of the rules but provide a level of detail that the Commission believes is unnecessary at the present time, and in some respects goes beyond what the Commission proposed. For example, Better Markets recommended that DCOs and FCMs be able to increase available credit in real-time and to have automatic push notification of acceptance or rejection from clearing. The first could conflict with risk management procedures that some DCOs or FCMs might wish to use. The second is likely to be in place at many firms, but the Commission continues to believe that it is appropriate to have a rule that sets a performance standard rather than specifying a particular means of achieving it. Fully automated systems would of course comply with the performance standard. Accordingly, the Commission has decided not to change the rule in the manner suggested by Better Markets and SG. The Commission, however, will monitor the implementation of this rule and may propose amendments in the future.

The Commission received numerous comments in the customer clearing documentation rulemaking emphasizing that it is imperative for effective risk management to have the shortest possible gap between execution and clearing. To permit

additional time as suggested by some of the commenters on this rule would increase risk for DCOs, clearing members, and market participants.

However, in light of commenters' concerns, the Commission is adopting §§ 1.75 and 23.611, which delegate to the Director of the Division of Clearing and Risk the authority to establish an alternative compliance schedule for requirements of §§ 1.74 and 23.610 for swaps that are found to be technologically ~~and~~ or economically impracticable for an FCM, SD, or MSP affected by §§ 1.74 or 23.610. The purpose of §§ 1.75 and 23.611 is to facilitate the ability of the Commission to provide a technologically practicable compliance schedule for affected FCMs, SDs, or MSPs that seek to comply in good faith with the requirements of §§ 1.74 or 23.610.

In order to obtain an exception under §§ 1.75 or 23.611, an affected FCM, SD, or MSP must submit a request to the Director of the Division of Clearing and Risk. FCMs, SDs, and MSPs submitting requests must specify the basis in fact supporting their claims that compliance with §§ 1.74 or 23.610 would be technologically or economically impracticable. Such a request may include a recitation of the specific costs and technical obstacles particular to the entity seeking an exception and the efforts the entity intends to make in order to ensure compliance according to an alternative compliance schedule. An exception granted under §§ 1.75 or 23.611 shall not cause a registrant to be out of compliance or deemed in violation of any registration requirements.

Such requests for an alternative compliance schedule shall be acted upon by the Director of the Division of Clearing and Risk or designees thereto within 30 days from the time such a request is received. If not acted upon within the 30 day period, such request will be deemed approved.

The Commission is adopting §§ 1.74, 23.610, and 39.12(b)(7) as proposed.

D. Post-trade Allocation of Bunched Orders

1. Introduction

Bunched orders are orders entered by an account manager on behalf of multiple customers, which are executed as a block and later allocated among participating customer accounts for clearing. Believing that procedures used in the futures markets could be adapted for use in the swaps markets, the Commission proposed § 1.35(a-1)(5)(iv).[47] It provided that allocations must be made as soon as practicable after execution but in any event no later than the following times: (1) for cleared transactions, sufficiently before the end of the day to ensure that clearing records identify the customer accounts, and (2) for uncleared trades, no later than the end of the day the swap was executed.

2. Summary of Comments

In comments filed in connection with proposed §§ 1.74, 23.610, and 39.12(b)(7), BlackRock and State Street stated that the Commission should clarify the rules to specifically allow for post-trade allocation of block trades. BlackRock also commented that the final rule should provide that at the time of trade execution, confirmation of trade economics may be done at the block level, and a two-hour delay be allowed before the trade must be submitted to a DCO for clearing.

In comments also filed in connection with proposed §§ 1.74, 23.610, and 39.12(b)(7), MFA and D. E. Shaw stated that it is not necessary to delay trades for post-execution allocation of trades to multiple funds. D. E. Shaw asserted that post-execution allocation

[47] See 76 FR 33066 (Jun. 7, 2011).

is a "red herring" and should not prevent the Commission from mandating real-time clearing in the proposal.

In a comment filed in connection with the proposed amendment to § 1.35, CME asserted that bunched orders in swaps should not be subject to the same type of regulatory regime as bunched orders in futures contracts because the "futures model" for treatment of bunched orders is not a suitable model for block trades of swaps. After a bunched trade in the futures market is accepted for clearing, an FCM generally holds the positions in a suspense account while awaiting allocation instructions from the asset manager. In contrast, the CME believes that an FCM holding bunched orders for swaps in a suspense account, while waiting for allocation instructions, may be exposed to substantially greater risk considering larger transaction sizes and the different risk profile of cleared swaps as compared to futures. CME stated that a time frame of two hours should allow sufficient time for asset managers to allocate block trades in swaps to their individual customers' accounts.

In contrast, in comments also filed in connection with proposed § 1.35, SDMA stated that there should be no delay for bunched orders that are allocated after execution. According to SDMA, the process for swaps trade allocation should be similar to that of the futures markets.

The Commission received no substantive comments regarding allocation of uncleared trades.

3. Discussion

For many years in the futures markets, bunched orders have been executed as a block for immediate acceptance into clearing and allocated into individual accounts later in the

day. Essentially, a "stand-by" clearing member guarantees the trades until they can be allocated. Consequently, there is no need for a two-hour delay.

The proposed amendments would apply the same process to swaps. By allowing post-trade allocation of bunched orders, the rule is responsive to all the comments. By not permitting a two-hour delay the rule is also responsive to the comments of State Street, MFA, D. E. Shaw, and SDMA, but is contrary to the comments of CME and BlackRock.

The Commission does not find persuasive the arguments that cleared swaps should be subject to a standard that differs in this regard from the standard for cleared futures. The Commission believes that a two-hour delay would create risk rather than mitigate it. First, the counterparty or counterparties to the trade would incur a delay in acceptance of their side into clearing because of the happenstance of being opposite a bunched order. This result is untenable in fast-moving markets. Second, the customers whose orders were being bunched would also suffer the same delay thereby incurring the same risks.

The futures model has worked well for many years. In most instances, the orders are successfully allocated and the stand-by FCM ultimately is not required to clear any trades. In those cases where there is a misallocation, it is corrected the next day and the stand-by FCM is compensated by the account manager. All parties receive the benefits of immediate acceptance into clearing. CME and BlackRock have not demonstrated why these procedures would not work for swaps.

The Commission believes that a similar analysis applies to uncleared swaps. Certainty of allocation by the end of the calendar day that a swap is executed will reduce

risk for both counterparties. The Commission received no comments indicating otherwise.

The Commission is adopting § 1.35(a-1)(5)(iv) as proposed.

IV. Clearing Member Risk Management

A. Introduction

CEA Section 3(b) provides that one of the purposes of the Act is to ensure the financial integrity of all transactions subject to the Act and to avoid systemic risk. CEA section 8a(5) authorizes the Commission to promulgate such regulations that it believes are reasonably necessary to effectuate any of the provisions or to accomplish any of the purposes of the Act. Risk management systems are critical to the avoidance of systemic risk, as evidenced by the statutory provisions cited below.

CEA section 4s(j)(2) requires each SD and MSP to have risk management systems adequate for managing its business. CEA section 4s(j)(4) requires each SD and MSP to have internal systems and procedures to perform any of the functions set forth in Section 4s.

CEA section 4d requires FCMs to register with the Commission. It further requires FCMs to segregate customer funds. CEA section 4f requires FCMs to maintain certain levels of capital. CEA section 4g establishes reporting and recordkeeping requirements for FCMs.

These provisions of law – and Commission regulations promulgated pursuant to these provisions – create a web of requirements designed to secure the financial integrity of the markets and the clearing system, to avoid systemic risk, and to protect customer funds. Effective risk management by SDs, MSPs, and FCMs is essential to achieving these

goals. For example, a poorly managed position in the customer account may cause an FCM to become undersegregated. A poorly managed position in the proprietary account may cause an FCM to fall out of compliance with capital requirements.

Even more significantly, a failure of risk management can cause an FCM to become insolvent and default to a DCO. This can disrupt the markets and the clearing system and harm customers. Such failures have been predominately attributable to failures in risk management.

Proposed § 1.73 set forth risk management requirements that would apply to clearing members that are FCMs; proposed § 23.609 would apply to clearing members that are SDs or MSPs. These provisions would require these clearing members to have procedures to limit the financial risks they incur as a result of clearing trades and liquid resources to meet the obligations that arise. The proposal required each clearing member to:

(1) establish credit and market risk-based limits based on position size, order size, margin requirements, or similar factors;
(2) use automated means to screen orders for compliance with the risk-based limits;
(3) monitor for adherence to the risk-based limits intra-day and overnight;
(4) conduct stress tests of all positions in the proprietary account and all positions in any customer account that could pose material risk to the futures commission merchant at least once per week;
(5) evaluate its ability to meet initial margin requirements at least once per week;
(6) evaluate its ability to meet variation margin requirements in cash at least once per week;
(7) evaluate its ability to liquidate the positions it clears in an orderly manner, and estimate the cost of the liquidation at least once per month; and
(8) test all lines of credit at least once per quarter.

Each of these items has been observed by Commission staff as an element of an existing sound risk management program at a DCO or an FCM.

B. Components of the Rule

The Commission received a total of 15 comment letters directed specifically at the proposed risk management rules.[48] A discussion of the comments received in response to each component of the rule follows.

1. Establish Credit and Market Limits and Automated Screening of Orders

a. Summary of Comments

FIA stated that it does not believe that "pre-execution" screening of orders is feasible in all market situations. For instance, the FIA noted four situations wherein "pre-execution screening" is not possible given current technology. Specifically, FIA does not believe that "pre-execution" screening is possible in the case of floor execution, trading advisors using "bunched" orders, give-up agreements, and traders using multiple trading platforms.

The CME also commented that automated screening is not feasible in a floor trading environment. The CME suggested that the Commission adopt the following language: "automated or otherwise appropriate means to screen orders for compliance with risk-base-limits."

ISDA made comments consistent with CME and recommended a more flexible approach. ISDA noted that the regulation may not take into account the manner in which swaps are executed.

b. Discussion

As noted previously, the Dodd-Frank Act requires the increased use of central clearing. In particular, Section 2(h) establishes procedures for the mandatory clearing of certain swaps. Central clearing will provide more stability to the markets, and increase

[48] Barnard; Futures Industry Association ("FIA"); SDMA; Better Markets; ICE; CME; Freddie Mac; ISDA; MGEX; MFA; Citadel; FHLB; Jeffries; Arbor; and Javelin.

transparency for market participants.[49] As stated in the Committee report of the Senate Committee on Banking, Housing, and Urban Affairs: "Increasing the use of central clearinghouses . . . will provide safeguards for American taxpayers and the financial system as a whole."[50]

The Commission has finalized extensive risk management standards at the DCO level. Given the increased importance of clearing and the expected entrance of new products and new participants into the clearing system, the Commission believes that enhancing the safeguards at the clearing member level is necessary as well.

Bringing swaps into clearing will increase the magnitude of the risks faced by clearing members. In many cases, it will change the nature of those risks as well. Many types of swaps have their own unique set of risk characteristics. The Commission believes that the increased concentration of risk in the clearing system combined with the changing configuration of the risk warrant additional vigilance not only by DCOs but by clearing members as well.

FCMs generally have extensive experience managing the risk of futures. They generally have less experience managing the risks of swaps. The Commission believes that it is a reasonable precaution to require that certain safeguards be in place. It would ensure that FCMs, who clear on behalf of customers, are subject to standards at least as stringent as those applicable to SDs and MSPs, who clear only for themselves. Failure to require SDs, MSPs, and FCMs that are clearing members to maintain such safeguards would frustrate the regulatory regime established in the CEA, as amended by the Dodd-

[49] The Dodd-Frank Wall Street Reform and Consumer Protection Act: Title VII, Derivatives, Mark Jickling & Kathleen Ann Ruane, 5 (Aug. 30, 2010).
[50] S. REP. NO. 111-176, at 32 (2010) (report of the Senate Committee on Banking, Housing, and Urban Affairs).

Frank Act. Accordingly, the Commission believes that applying the risk-management requirements in the proposed rules to SDs, MSPs, and FCMs that are clearing members are reasonably necessary to effectuate the provisions, and to accomplish the purposes, of the CEA.

The Commission does not intend to prescribe the particular means of fulfilling these obligations. As is the case with DCOs, clearing members will have flexibility in developing procedures that meet their needs. For example, items (1) and (2) could be addressed through simple numerical limits on order or position size, or through more complex margin-based limits. Further examples could include price limits that would reject orders that are too far away from the market, or limits on the number of orders that could be placed in a short time.

These proposals are consistent with international standards. In August 2010, the International Organization of Securities Commissions issued a report entitled "Direct Electronic Access to Markets."[51] The report set out a number of principles to guide markets, regulators, and intermediaries. Principle 6 states that:

> A market should not permit DEA [direct electronic access] unless there are in place effective systems and controls reasonably designed to enable the management of risk with regard to fair and orderly trading including, in particular, automated pre-trade controls that enable intermediaries to implement appropriate trading limits.

Principle 7 states that:

> Intermediaries (including, as appropriate, clearing firms) should use controls, including automated pre-trade controls, which can limit or prevent a DEA Customer from placing an order that exceeds a relevant intermediary's existing position or credit limits.

[51] The report can be found at www.iosco.org.

Over the years, "rogue" traders have caused substantial financial damage to both small and large firms. The size or sophistication of the firm has not provided comprehensive protection. Traders have found ways to exploit gaps in internal controls. Automated screening procedures, such as Globex Credit Controls, are already in place in many markets and have proven to be effective tools for reducing risk. Therefore, the Commission believes that as proposed, the rule should require clearing members to use automated means for screening orders executed on automated trading systems.

In response to the comments, the Commission has determined that, for non-automated markets such as open outcry exchanges or voice brokers, the rules would permit other forms of internal controls. For example, a clearing member cannot use an automated system to screen the orders of a floor trader. Proprietary or customer orders executed by open outcry or voice broker can be screened automatically if they are routed automatically. Many orders, however, continue to be placed by telephone. It is not practicable at this time to use automated means to screen such orders. A clearing member, however, can actively monitor a trader's activities and be in communication if the trader approaches a limit. To incorporate this approach, the Commission is revising §§ 1.73(a)(2)(ii), 1.73(a)(2)(iii), and 23.609(a)(2)(ii) using language suggested by ISDA. Specifically, as amended, these rules provide that clearing members must "establish and maintain systems of risk controls reasonably designed to ensure compliance."

The Commission believes that, as amended, the rules will be responsive to the comments of FIA, CME, and ISDA. They will continue to emphasize the key role that order screening can play in managing risk while making accommodation for certain circumstances where automated screening may not be possible or practicable at this time.

In response to the comments, the Commission has also determined to make changes with regard to give-ups and bunched orders. Give-ups are trades where the execution function and the clearing function are performed by different firms. Revised paragraph (2)(iv) requires the clearing firm, which bears the financial risk of the trade, to set limits and communicate them to the executing firm, which would apply them. This arrangement is consistent with current practice. The uniform give-up contract contains a provision allowing a clearing firm to establish limits on the trades it will accept from the executing firm.

To the extent the executing firm is an SD or MSP, and the clearing firm is an affiliated FCM, the firms will also have to comply with the conflict of interest rules for SD/MSPs and the conflict of interest rules for FCMs.[52] Those rules address appropriate partitions between the trading units of an SD/MSP and the clearing units of an affiliated FCM. For example, recently-promulgated § 23.605(d)(1)(iv) prohibits an SD/MSP from interfering with the setting of risk tolerance levels by an affiliated FCM.

As noted above, for bunched orders, typically one firm acts as a "stand-by" clearing firm for purposes of getting the trade executed, but before the end of the day, the block is broken up and assigned among multiple clearing members, each of whom is acting on behalf of a particular customer.

Revised paragraph (2)(v)(A) requires the stand-by clearing firm to establish limits for the block account and screen the order. Revised paragraph (2)(v)(B) requires each

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[52] See "Swap Dealer and Major Swap Participant Recordkeeping and Reporting, Duties, and Conflicts of Interest Policies and Procedures; Futures Commission Merchant and Introducing Broker Conflicts of Interest Policies and Procedures; Swap Dealer, Major Swap Participant, and Futures Commission Merchant Chief Compliance Officer," available at http://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/DF_4_BusConductStandardsInternal/ssLINK/federalregister022312b.

ultimate clearing firm to establish limits for each of its customers and enter an agreement with the account manager under which the account manager would screen orders for compliance. Revised paragraph (2)(v)(C) requires each ultimate clearing firm to establish controls to enforce its limits. The revisions adjust the rule to take into account the more complex procedures entailed in processing bunched orders. They narrow the scope of the screening required by various clearing participants from what was originally proposed.

To the extent the account manager or one of the customers is an SD/MSP and one of the clearing firms is an affiliated FCM, the firms also will have to comply with the conflict of interest rules for SD/MSPs and the conflict of interest rules for FCMs. As noted above, those rules address appropriate partitions between the trading units of an SD/MSP and the clearing units of an affiliated FCM.

The Commission is amending § 1.73(a)(2) and § 23.609(a)(2) to read as follows:

Sec 1.73

. . .

(2) Screen orders for compliance with the risk-based limits in accordance with following:

(i) When a clearing futures commission merchant provides electronic market access or accepts orders for automated execution, it shall use automated means to screen orders for compliance with the limits;

(ii) When a clearing futures commission merchant accepts orders for non-automated execution, it shall establish and maintain systems of risk controls reasonably designed to ensure compliance with the limits;

(iii) When a clearing futures commission merchant accepts transactions that were executed bilaterally and then submitted for clearing, it shall establish and maintain systems of risk management controls reasonably designed to ensure compliance with the limits;

(iv) When a firm executes an order on behalf of a customer but gives it up to another firm for clearing, the clearing futures commission merchant shall enter into an agreement in advance with the executing firm pursuant to which the clearing futures commission merchant establishes risk-based limits for that

customer and the executing firm screens orders for compliance with those limits in accordance with paragraph (a)(2)(i) or paragraph (a)(2)(ii) as applicable; and
(v) When an account manager bunches orders on behalf of multiple customers for execution as a block and post-trade allocation to individual accounts for clearing:
(A) the futures commission merchant that initially clears the block shall establish risk-based limits for the block account and screen the order in accordance with paragraph (a)(2)(i) or paragraph (a)(2)(ii) as applicable;
(B) the futures commission merchants that ultimately clear the allocated trades on behalf of customers shall enter into an agreement in advance with the account manager establishing risk-based limits for each customer and requiring the account manager to screen orders for compliance with those limits; and
(C) the futures commission merchants that ultimately clear the allocated trades on behalf of customers shall establish and maintain systems of risk management controls reasonably designed to ensure compliance with the limits.

Sec. 23.609.
. . .
(2) Screen orders for compliance with the risk-based limits in accordance with following:
(i) for transactions subject to automated execution, the clearing member shall use automated means to screen orders for compliance with the risk-based limits; and
(ii) for transactions subject to non-automated execution, the clearing member shall establish and maintain systems of risk controls reasonably designed to ensure compliance with the limits.

2. Stress Tests

a. Summary of Comments

Chris Barnard and Better Markets both recommended that the Commission require specific stress tests. Barnard recommended that the Commission adopt a minimum standard and Better Markets recommended an "extreme but plausible" standard for stress tests. In addition, Better Markets believes that stress test results should be reported to the Commission and the relevant DCO. FHLB recommended that stress test results be publicly disclosed. FHLB believes that public disclosure of stress test results would allow customers to mitigate risk.

b. Discussion

Stress tests are an essential risk management tool. The purpose in conducting stress tests is to determine the potential for significant losses in the event of extreme market events and the ability of traders and clearing members to absorb the losses.

The Commission intentionally refrained from setting specific stress tests levels or a minimum threshold. The Commission believes that clearing members are in the best position to design stress tests based on their knowledge of markets and the types of customers they carry. In addition, the Commission believes that specifying certain stress tests might stifle innovation or cause firms to use minimum levels to meet regulatory compliance rather than implementing a vigorous risk management program. This approach is consistent with the approach recently adopted by the Commission for DCO stress tests. The Commission intends to monitor the implementation of this rule to determine whether clearing members are routinely conducting stress tests reasonably designed for the types of risk the clearing members and their customers face.

The Commission believes that the concept of "extreme but plausible" conditions is commonly used and was implicit in the proposal. The Commission is adding the phrase to the rule text for clarity.

The Commission believes that public disclosure of stress test results could be a disincentive to aggressive stress testing. Moreover, disclosure of results could have the effect of improper disclosure of confidential position information.

The Commission is adopting the provisions as proposed, with amendments to §§ 1.73(a)(4) and 23.609(a)(4) to incorporate the phrase "extreme but plausible market conditions."

3. Margin Evaluation

a. Summary of Comments

ISDA and FIA believe that the requirement to evaluate initial margin once per week is unclear. ISDA pointed out that a clearing member generally knows the amount of initial margin and collects it promptly.

The Commission received no comments regarding §§ 1.73(a)(6) and 23.609(a)(6) regarding variation margin.

b. Discussion

The purpose of this provision is to require clearing firms to evaluate their ability to deal with certain contingencies on a routine basis. For example, a DCO might raise margin requirements, or option positions might be exercised, or a customer might default on a margin call. The clearing firm should make sure that it has resources available to meet its continuing obligations under such circumstances.

The Commission is adopting §§ 1.73(a)(5), 1.73(a)(6), 23.609(a)(5), and 23.609(a)(6) as proposed.

4. Estimated Cost of Liquidation

a. Summary of Comments

FIA commented that "even in normal markets, estimating the costs of liquidating such positions in an orderly manner will be difficult at best. In times of market stress, such estimates will be impossible."

b. Discussion

The Commission recognizes that estimating the cost of liquidation is at times difficult. But the inevitable imprecision of any estimate does not justify abandoning efforts to quantify potential losses.

The purpose of the calculation is to alert the clearing firm to potential risks that might otherwise go undetected. This exercise could lead a clearing firm to decide: (1) to arrange for additional financing to cover a potential loss; or (2) to reduce the positions prior to a period of market stress. Commission staff perform stress tests of FCM positions and have alerted FCMs about potential losses. Based on Commission staff's experience in this area, the Commission believes that this is a topic that has not been fully addressed by some clearing members in recent years.

In response to commenters, the Commission has decided to modify § 1.73(a)(~~8~~7) to require estimation of liquidation costs once per quarter, rather than once per month.

Additionally, the Commission is re-numbering § 23.609(a)(7) to § 23.609(a)(8), and renumbering § 23.609(a)(8) to § 23.609(a)(7), in order to follow the parallel structure in § 1.73.

The Commission is adopting §§ 1.73(a)(8) and 23.609(a)(7) with the modifications discussed above.

5. Testing Lines of Credit

a. Summary of Comments

The CME commented that the requirement to test lines of credit should only be done on an annual basis rather than a quarterly basis. The CME believes that quarterly testing is not cost efficient. ISDA sought clarification on whether the test requires an actual drawing of funds or an assessment of conditions precedent to drawing.

b. Discussion

The Commission accepts that quarterly testing might not be cost efficient under all circumstances. Nonetheless, the Commission encourages clearing members to test lines

of credit more frequently based on market and credit events. For instance, if a line of credit is in place with a bank that has recently suffered a credit rating downgrade, a test may be appropriate.

The Commission believes that the actual drawing of funds is essential to testing a line of credit. Among other things, the test should ensure the ability of the bank or other institution to move the funds in a timely fashion and that the clearing member can assess its ability to approve the drawing and properly make accounting entries. This approach is consistent with the approach the Commission recently adopted for DCOs.

The Commission is adopting §§ 1.73(a)(8) and 23.609(a)(7) as proposed, but with an amendment to provide for annual – rather than quarterly – testing of lines of credit.

6. Vagueness, Conflict, and/or Overlap among Regulations

a. Summary of Comments

FIA expressed concern that paragraphs (1), (4), (5), and (6) of § 1.73 are too vague. FIA also expressed concern that the limits required by § 1.73 "may conflict with the provisions of proposed Rule 1.72(c), which provides that an FCM may set only 'an overall limit for all positions held by the customer' at the FCM. Further, such limits may indirectly 'limit' the number of counterparties with whom a customer may enter into a trade, in apparent violation of proposed Rule 1.72(b)." Regulation 1.72 was proposed in the customer clearing documentation rules[53] and is discussed in Part II, above.

ISDA commented that the then-proposed § 23.600 imposes a risk management program for SDs and MSPs that must include "policies and procedures to monitor and manage, market, credit, liquidity, foreign currency, legal, operational, and settlement risk, as well as controls on business trading." ISDA believes that the broad requirements of §

[53] See 76 FR 45730, Aug. 1, 2011.

23.600 that pertain to liquidity and funding make proposed § 23.609(a)(5)-(8) redundant. The Commission recently promulgated § 23.600 as a final rule.[54]

b. Discussion

The Commission does not believe that § 1.73 is too vague. Paragraph (1) addresses risk-based limits, paragraph (4) addresses stress tests, and paragraphs (5) and (6) address margin. While FIA asserts that these requirements are vague, it provides no additional detail on the issue.

The regulation was intentionally drafted in a non-prescriptive manner. Risk management is a complex process that requires firms to make judgment calls on a daily basis. Moreover, each firm has a different customer base, different resources, and a different risk appetite. The Commission envisions that each clearing member will comply with § 1.73 using procedures and technology appropriate to its business model and customer base. As drafted, these provisions allow flexibility and innovation in complying with the regulation.

The Commission does not believe that §§ 1.73 and 1.72 conflict. As proposed, § 1.72(b) would prohibit limits as to the number of counterparties, whereas § 1.73 would require limits set according to criteria such as position size or margin amount. FIA asserts that the regulations could conflict because § 1.73 may "indirectly" limit the number of counterparties. A position limit, of course, can have the effect of limiting the number of counterparties in the sense that if a trader can only execute 100 lots, the trader

[54] "Swap Dealer and Major Swap Participant Recordkeeping and Reporting, Duties, and Conflicts of Interest Policies and Procedures; Futures Commission Merchant and Introducing Broker Conflicts of Interest Policies and Procedures; Swap Dealer, Major Swap Participant, and Futures Commission Merchant Chief Compliance Officer," available at http://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/DF_4_BusConductStandardsInternal/ssLINK/federalregister022312b.

cannot have more than 100 counterparties. But such an indirect result is distinguishable from the conduct prohibited by § 1.72(b) – the deliberate setting of limits on the number of counterparties. The first is a legitimate risk management tool; the second is an unnecessary impediment to the free and open trading that would promote liquidity.

Section 1.72(c) would prohibit only limits on the size of positions with specific counterparties. It does not prohibit limits tied to executing firms. Moreover, it specifically provides that overall position limits are permissible. Thus, there is no conflict between § 1.72(c) and § 1.73.

The Commission also does not believe that the broad requirements of the recently-promulgated § 23.600 make proposed § 1.73 redundant. Section 23.600 sets out broad principles applicable to all SDs and MSPs. As proposed, § 23.609 would apply only to those SDs and MSPs that are clearing members of a DCO. The Commission believes that if an SD or MSP takes on the additional risks and responsibilities of clearing, it should undertake risk management procedures similar to those undertaken by clearing FCMs for their proprietary accounts. Clearing members pose risks to DCOs and users of DCOs that are not posed by SDs and MSPs that are not clearing members.

V. Effective Dates

A. Summary of Comments

Arbor, Citadel, and Eris urged the Commission to prioritize the entire rule in the final rulemaking process.

The Banks, DB, EEI, and ISDA commented that the Commission should not rush this proposal.

Wells Fargo commented that the Commission should delay compliance until most industry systems meet the real-time acceptance standard. LCH requested that the Commission delay compliance for 9 months, if the rules are adopted as proposed. AllianceBernstein commented that the Commission's recently proposed phased implementation provides ample time for the market to make final preparations, and no "interim" execution documentation arrangements are necessary. Morgan Stanley stated that real-time clearing and risk limit compliance verification cannot be developed quickly enough to abandon trilateral agreements.

B. Discussion

This rulemaking includes rules applicable to FCMs, SDs, MSPs, DCMs, SEFs, and DCOs. In addressing implementation, it is important to distinguish between FCMs, DCMs, and DCOs, on the one hand, and SDs, MSPs, and SEFs, on the other.

FCMs, DCMs, and DCOs are currently involved in clearing swaps. Entity definitions are not necessary for them. Product definitions are not necessary for the implementation of the rules applicable to them. The products currently being cleared as swaps by DCOs are commonly characterized as such by market participants. To delay implementation of these rules pending implementation of the further product definition rules would be to deny market participants pricing, operational, and risk-management benefits unnecessarily.

No firms are currently registered as SDs, MSPs, or SEFs. Therefore, the rules applicable to these entities will have no practical effect until other rulemakings are completed, such as the further entity definition rulemaking. Nevertheless, many entities currently expect to operate as SDs, MSPs, or SEFs, regardless of the precise contours of

the entity definitions. It would be more efficient for such entities, particularly those that are currently active in the markets, to develop their systems and procedures in anticipation of being subject to these rules as soon as they become applicable. Indeed, failing to take such measures would disadvantage those that did not prepare for the imminent regulatory framework. This approach would also avoid temporary gaps or discrepancies in the system of rules addressing client clearing documentation, trade processing, and clearing member risk management resulting from differing implementation schedules for various entities.

As discussed above, the Commission believes that implementation of these rules is essential to effective clearing of swaps. The Commission has determined that for FCMs, DCMs, and DCOs, these rules shall become effective October 1, 2012. For SDs and MSPs, these rules shall become effective on the later of October 1, 2012, or the date that the registration rules become effective.[55] For SEFs, these rules shall become effective on the later of October 1, 2012, or the date that the rules implementing the core principles for SEFs become effective.[56] The Commission believes that this approach strikes an appropriate balance between those commenters who urged implementation as quickly as possible and those who urged delayed implementation.

VI. Consideration of Costs and Benefits

Introduction:

CEA Section 15(a) requires the CFTC to consider the costs and benefits of its action before promulgating a regulation under the CEA, specifying that the costs and benefits shall be evaluated in light of five broad areas of market and public concern: (1)

[55] Registration of Swap Dealers and Major Swap Participants, 77 FR 2613 (Jan. 19, 2012).
[56] Core Principles and Other Requirements for Swap Execution Facilities, 76 FR 1214 (Jan. 7, 2011).

protection of market participants and the public; (2) efficiency, competitiveness and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations.[57] To the extent that these final regulations repeat the statutory requirements of the Dodd-Frank Act, they will not create costs and benefits beyond those resulting from Congress's statutory mandates in the Dodd-Frank Act. However, to the extent that the regulations reflect the Commission's own determinations regarding implementation of the Dodd-Frank Act's provisions, such Commission determinations may result in other costs and benefits. It is these other costs and benefits resulting from the Commission's determinations pursuant to and in accordance with the Dodd-Frank Act that the Commission considers with respect to the Section 15(a) factors.

The regulations contained in this Adopting Release were proposed in four separate notices of proposed rulemaking ("NPRMs"). Sections 1.72, 1.74, 23.608, 23.610, 39.12(a)(1)(iv), and 39.12(b)(7) were proposed in Customer Clearing Documentation and Timing of Acceptance for Clearing,[58] sections 23.506, 37.702(b), and 38.601(b) were proposed in Requirements for Processing, Clearing, and Transfer of Customer Positions,[59] sections 1.73 and 23.609 were proposed in Clearing Futures Commission Merchant Risk Management,[60] and 1.35(a-1)(5)(iv) was proposed in Adaptation of Regulations to Incorporate Swaps.[61] The Commission is finalizing the rules contained in this Adopting Release together because they address three overarching, closely-connected aims: (1) non-discriminatory access to counterparties and clearing; (2) straight-through

[57] 7 U.S.C. 19(a).
[58] See 76 FR 45730 (Aug. 1, 2011).
[59] See 76 FR 13101 (Mar. 10, 2011).
[60] See 76 FR 45724 (Aug. 1 2011).
[61] See 76 FR 33066 (Jun. 6, 2011).

processing; and (3) effective risk management among clearing members. Each of these provides substantial benefits for the markets and market participants.

The regulations related to non-discriminatory access concern customer clearing documentation. Specifically, they prohibit FCMs, SDs, MSPs, and DCOs from entering into agreements, including those known in the industry as "trilateral agreements," with terms restricting an FCM's customer's ability to access all willing counterparties in the market and obtain a swap on reasonably competitive terms.[62] Open access, unrestrained by contractual terms of this type, is critical to the efficiency and financial integrity of the swap markets.

This first set of rules is designed to avoid the undesirable consequences likely to result from trilateral agreements, which include limits on the range of eligible counterparties with whom market participants can transact, reduced competition for customers' business, fragmentation of customers' trading limits at the FCM, and distorted price discovery.[63] Reduced competition in this context may lead to wider spreads, higher transaction fees (i.e., increased costs for customers), and reduced market efficiency. Moreover, limiting a market participant's access to less than all willing counterparties, including those offering trades on terms approximating the best available in the market could undermine price discovery, and market efficiency. The first cluster of rules seeks to mitigate these problems through provisions fostering open access to all available counterparties and democratized access to clearing services. To that end, it prevents FCMs, SDs, MSPs, and DCOs from entering into any agreement that would: (a) disclose

[62] See §§ 1.72, 23.608, and 39.12(a).
[63] Trilateral agreements were introduced in June 2011. On August 1, 2011 the Commission issued the NPRM of this rule prohibiting certain terms that are central to the trilateral agreements and as a consequence, adoption of the agreements thus far has been extremely limited.

the identity of a customer's original executing counterparty to the FCM, SD, or MSP; (b) limit the number of counterparties available to the customer; (c) set any limits on the size of position a customer may take (other than the general limit established by their FCM); (d) impede a customer's access to trades that approximate the best terms available; or (e) prevent compliance with timeframes for processing swaps that are required by other parts of these rules.

A second group of regulations mandates straight-through processing—rapid processing of swap transactions, including rapid submission to the DCO for acceptance or rejection from clearing—for swaps required to be cleared or that the counterparties elect to clear. In this regard, the regulations impose requirements on FCMs, SDs, MSPs, DCMs, SEFs, and DCOs that, taken together, are designed to ensure that counterparties know whether a swap will be accepted for clearing at, or soon after, the time of execution which is a critical condition for eliminating counterparty risk that undermines democratized access to the swap markets.[64] When two parties enter into a bilateral swap transaction with the intention of clearing a swap, each party bears counterparty risk with respect to the other until the swap enters clearing. Once the swap enters clearing, the clearinghouse becomes the counterparty to each side of the trade, which minimizes and standardizes counterparty risk. To the extent that there is a period of time between execution and clearing, counterparty risk may develop as post-execution market movements impact the swap's value and each party could face significant costs if the swap is eventually rejected from clearing and subsequently broken. Both counterparties run the risk that they may have to replace the swap under different, less desirable terms if the market has moved against them during the intervening time. In addition, SDs,

[64] See §§ 1.35, 1.74, 23.506, 23.610, 37.702, 38.601, and 39.12(b) of the Commission's regulations.

whether providing liquidity to a non-SD or SD counterparty, may have to unwind or offset any positions they have taken on to hedge the original swap; this can also be costly, again, particularly if the market has moved against them since the execution of the original swap. Bilateral agreements typically address such "breakage" costs, but the effectiveness of those provisions could be compromised if either counterparty is unwilling or unable to make the other whole for losses. Such costs are potentially significant, particularly when the markets are volatile and the latency period is long, giving SDs an incentive to discriminate among counterparties on the basis of their credit quality. To mitigate those costs and promote more democratized access to the markets, it is critical that executed swap transactions be accepted or rejected from clearing quickly.

These rules contain several requirements that are designed to ensure that swaps are processed and accepted or rejected promptly from clearing, including requirements that FCMs, SDs, MSPs, SEFs, DCMs, and DCOs coordinate with one another to ensure they have the capacity to accept or reject trades "as quickly as technologically practicable if fully automated systems were used." For trades executed on a DCM or SEF, the Commission anticipates that processing and submitting a trade for clearing would be near real-time, thus substantially eliminating the potential for significant counterparty risk accumulation during the latency period. For trades that are not executed on an exchange, but are required to be cleared, the rules require submission for clearing "as soon as is technologically practicable after execution" but no later than by the close of business on the day of execution. Similarly, swaps not executed on an exchange and for which clearing is elected by the counterparties (but not required by law) must also be submitted

for clearing as soon as technologically practicable, but not later than the day following the latter of execution or the decision to clear.

The Commission expects that these rules requiring coordination to ensure rapid processing and acceptance or rejection of swaps for clearing will be beneficial in several respects. First, they will promote rapid adoption in the market of currently existing technologies that will make possible near real-time processing of exchange traded swaps. For trades that are pre-screened, or executed on an exchange, this will virtually eliminate counterparty credit risks associated with clearing rejection. The rules will also significantly reduce the amount of time needed to process swaps that are not traded on an exchange; although costs associated with latency-period counterparty credit risk cannot be completely eliminated in this context, the rules will substantially reduce the need to discriminate among potential counterparties in off-exchange trades, as well as the potential costs associated with rejected trades. By reducing or eliminating the counterparty risk that could otherwise develop during the latency period, these rules promote a market in which all eligible market participants have access to counterparties willing to trade on terms that approximate the best available terms in the market. This rule may improve price discovery and promote market integrity.

The third set of rules in this Adopting Release requires that FCMs, SDs, and MSPs who are clearing members of a DCO implement sound risk management practices that help ensure their financial strength. A DCO's financial strength depends on the continued financial strength of its clearing members. The Commission believes that requiring clearing members to engage in certain risk management procedures will

provide additional assurance of their ability to meet their financial obligations to their respective DCOs, particularly in times of market stress.

The third group of rules in this Adopting Release therefore requires clearing members to establish overall risk-based position limits for their proprietary trading accounts and each of their customer accounts, and to screen trades for compliance with those limits. The rules also require clearing members to monitor for adherence to such risk-based position limits, both intra-day and overnight; to conduct rigorous stress tests on significant accounts at least once per week; to evaluate their ability to meet initial and variation margin requirements at least once per week; to evaluate the probable cost of liquidating various accounts at least once per month; to test all lines of credit at least once per year; and to establish procedures and records that ensure and verify their compliance with these requirements. Many of these requirements reflect common practices for clearing members. These rules promote consistent use of risk management best practices among clearing members, while also allowing flexibility to encourage innovation and adaptation to the specific operating requirements of diverse clearing members. The Commission anticipates that the requirements themselves will help to ensure that clearing members and their respective DCOs remain financially sound during periods of market stress. Moreover, the Commission believes that the flexibility these requirements allow will minimize attendant costs and enable members to adapt their risk management practices to new market demands and develop more effective strategies for monitoring and managing risk.

In the sections that follow, the Commission evaluates the costs and benefits relevant to each of the three groups of rules pursuant to Section 15(a) of the CEA. Each section

specifically addresses the individual Section 15(a) factors with respect to the rule group and responds to comments pertaining to that group. In its analysis, the Commission has endeavored, where possible, to quantify costs and benefits. However, the costs and benefits are either indirect, highly variable, or both and therefore are not subject to reliable quantification at this time. Nevertheless, the Commission has considered all the comments received, a broad range of costs and benefits pertaining to democratized swap market access, improvements and challenges in risk management, development and implementation of necessary technology, market liquidity, and several others as detailed below.

Cost Benefit Consideration by Rule Group

1. Customer Clearing Documentation

Sections 1.72, 23.608, and 39.12(a)(1)(vi) restrict FCMs, SDs and MSPs, and DCOs, respectively, from entering into any arrangements that would (a) disclose the identity of a customer's original executing counterparty to any FCM, SD, or MSP; (b) limit the number of counterparties with whom a customer may trade; (c) restrict the size of a position that the customer may take with any individual counterparty apart from the overall limit for all positions held by the customer at the FCM; (d) limit a customer's access to trades on terms that have a reasonable relationship to the best terms available; or (e) prevents compliance with other regulations requiring rapid processing and acceptance or rejection from clearing.

The Commission believes that these rules proscribe certain terms in trilateral agreements that were proposed by some SDs and FCMs. However, the Commission notes that trilateral agreements were not used in swap markets prior to June 2011. SDs

historically have provided liquidity and managed risk without the use of trilateral agreements, and the Commission understands that such agreements have not yet been widely adopted. Therefore, it is unlikely that these rules, by preventing certain terms in trilateral agreements, will cause widespread changes in current market practices for managing counterparty risk or for negotiating bilateral agreements.[65] Moreover, the rules adopted in this Adopting Release will enhance risk management in other ways, obviating any perceived need for terms in trilateral agreements that can harm market competitiveness, efficiency, and price discovery. In that context, the Commission concludes that these changes are justified.

a. Protection of Market Participants[66] and the Public

The Commission is concerned that by giving FCMs the ability to establish and communicate sub-limits on the positions a specific SD may clear with a specific customer, the trilateral agreements may allow FCMs to influence the amount of business that a customer conducts with specific counterparties, or to constrain the number or choice of counterparties with whom a customer is able to trade. This concern is amplified because a number of FCMs have affiliated SDs who (along with other SDs with whom the FCM-affiliated SD competes for swap transaction business) are potential counterparties to the FCM's customers. To the extent that FCMs could use terms in trilateral agreements to influence a customer's choice from among potential SD counterparties, the agreements could provide a means for FCMs to direct business toward an associated SD (or to raise the cost of doing business with an unassociated SD) to the

[65] To the extent that changes will occur, the costs attendant to them are indirect and cannot be estimated without data that is not available at this time.

[66] The term "market participants" as it is used throughout the cost benefit considerations section includes SDs, MSPs, FCMs, and the customers of FCMs (i.e., SD, MSP, and non-SD/MSP swap counterparties).

diminution of competition to provide swap liquidity generally; in this way, the agreement may work to the disadvantage of those market participants that might benefit from better competition. Moreover, by limiting a customer's range of potential counterparties and the size of positions that may be entered with specific counterparties, the FCM establishes a condition that in some circumstances could preclude matching of the customer's order with the counterparty that is willing to provide the best available terms in the market at that time. This sub-optimal outcome increases costs for the customer, and any systematic increases in costs to the customer will indirectly impact prices that the public ultimately pays for related goods and services.

In addition, such limitations also impose costs on potential counterparties who are prevented from trading with customers by restrictions in the trilateral agreements. If those counterparties are dealers, they lose the opportunity to win that customer's business. If those counterparties are non-dealers, they lose the liquidity that would have otherwise been available to them as a consequence of the customer's need to execute a swap. Last, an FCM could, intentionally or unintentionally, signal to the market information about the customer through designation notices. For example, clearing members may be more likely to reduce a customer's limits during a time of market stress. Communicating reductions on various sub-limits to potential SD counterparties may signal (perhaps wrongly) that the credit quality of the customer is deteriorating. This signal could make it more difficult for the customer to transact at a time when their ability to transact is particularly critical.

These potential costs to customers and the public will be forestalled or altogether eliminated by these rules. These benefits, however, are unquantifiable for several

reasons. First, many of the potential costs and benefits associated with trilateral agreements are indirect and dispersed to a degree that they would be difficult to estimate even if there were ample data available. Second, ample data is not available. The Commission does not have any data that characterizes pricing, liquidity, or other important variables in the presence and absence of trilateral agreements. Last, trilateral agreements were introduced in mid-June 2011, and the Commission believes that adoption of trilateral agreements thus far has been extremely limited. Further, the Commission believes that the NPRM of this rule, which was released a few weeks after trilateral agreements were introduced, may be a primary factor deterring rapid adoption of these agreements.[67] To the extent that this is correct, the current rate of adoption and impact on the market is unlikely to be a reflection of what the impact of trilateral agreements would be in the absence of this rule. In other words, even if the Commission had the data necessary to estimate the current impact of trilateral agreements (which it does not), those estimates would not accurately reflect the potential impact of these agreements. However, by prohibiting contractual terms that would limit the number of potential counterparties, set sub-limits on a customer's positions, or restrict a customer's access to terms reasonably related to the best terms available in the market, these rules provide significant protection to market participants.

With respect to the customer-identity nondisclosure requirement, several commenters stated that protecting anonymity is critical as a condition for open, efficient, and competitive swap markets.[68] Maintaining the anonymity of a customer's counterparty prevents the clearing member from sharing with any affiliated SDs

[67] See 76 FR 45730, Aug. 1, 2011.
[68] See MFA, Arbor, SIFMA, D. E. Shaw, AIMA, and Vizer.

competitively sensitive information about its customers' counterparties—who may be competitors and/or subsequent swap counterparties to the affiliated SD—that affiliated SDs can use for their own gain (and that of the SD/FCM affiliate group). This rule, together with the rule that prevents FCMs from establishing sub-limits, prohibits arrangements that allow FCMs to share competitively sensitive information that could undermine competition to provide swap liquidity—including information that provides transparency into customer swap positions and exposures. In so doing, the rules better protect those swap counterparty market participants that benefit from greater competition (e.g. as may be reflected in improved bid/ask spreads) to provide the desired swaps. The value of such protection would vary depending on the specific type and timing of information that is communicated as well as the role and incentives of the entity receiving that information relative to the entity about which the information is disclosed. These factors are highly variable and impracticable to quantify, and, as a consequence, the Commission does not have adequate information to reasonably estimate the additional costs that might be caused by such disclosures, or the value of preventing such costs.

In addition, SDs, FCMs, and FCM customers may soon expend resources negotiating trilateral agreements. By prohibiting certain provisions from inclusion in trilateral agreements, these rules reduce the likelihood that SDs, FCMs, and customers will enter into them. To the extent that this occurs, SDs, FCMs, and customers will save the substantial costs that otherwise would be required to negotiate such agreements.[69] Vanguard, for example, estimates that, if it was forced by SDs to implement trilateral agreements, it may have to negotiate and enter into approximately 4,800 new trilateral

[69] See AllianceBernstein, Citadel, D. E. Shaw, MFA, SIFMA, and Vanguard.

agreements per year.[70] In addition, those agreements would create significant administrative and ongoing legal costs associated with review, periodic update, and, for customers, compliance to monitor their own activities. Some commenters suggested that the resources necessary to create and administer trilateral agreements would divert resources from implementing market infrastructure that is necessary to facilitate straight through processing.[71]

The Commission recognizes that prohibiting certain arrangements that are currently in trilateral agreements may increase counterparty risks (costs) that SDs face due to the possibility that swaps they enter could be rejected from clearing. Trilateral agreements are intended to increase the degree of the SD's certainty that trades with certain customers and within certain limits will be accepted for clearing. The prohibitions contained in the first group of rules are likely to prevent SDs from using trilateral agreements in this way, creating certain potential costs for the SDs who have established trilateral agreements with some of their customers and the customers' FCMs.[72] However, as noted above, there are also significant costs associated with trilateral agreements. Moreover, in the Commission's judgment, provisions contained within the second cluster of rules (i.e., rules pertaining to straight-through processing) will mitigate the potential costs to SDs and other market participants substantially. More specifically, as discussed below, the second group of rules mitigates costs associated with pre-clearing-approval

[70] See Vanguard.
[71] See e.g., Citadel, Alliance Bernstein, and MFA.
[72] These costs, if compared against the baseline of current market practice, depend on the extent to which trilateral agreements containing terms proscribed in these rules are currently being used. Based on anecdotal feedback from market participants, the Commission believes that trilateral agreements have not yet been widely adopted. Moreover, as suggested above, the Commission believes that requiring more rapid swap processing and clearing determinations will offset these costs, diminishing them significantly over time. However, the Commission does not have sufficient data regarding the number of trilateral agreements currently in place, or the number and terms of swap transactions that they impact, to estimate these costs.

counterparty risk through straight-through-processing requirements; the Commission anticipates these rules will drive rapid implementation of existing market technology to substantially narrow the window of counterparty risk for SDs between execution and clearing acceptance/rejection.

Moreover, commenters have suggested that in certain circumstances, the sub-limits associated with trilateral agreements may actually exacerbate the counterparty risk problem by delaying processing and increasing the latency period during which counterparty exposure develops.[73] If a customer enters a swap with an SD without a trilateral agreement in place, the FCM may need to check with and adjust the limits of various SDs who do have trilateral agreements set up with that customer before making a clearing determination. The administrative requirements of these steps could delay clearing. By prohibiting agreements that create such delays, the rules reduce the latency period for some transactions, which also reduces the amount of counterparty risk that can develop during that period.

Notwithstanding the inability to quantify in dollar terms the costs of this change in risk avoidance and mitigation practice, in the Commission's judgment the change is justified by the critical benefits that the rules provide regarding open access to, and democratization of, swap markets.

b. Efficiency, Competitiveness and Financial Integrity of Markets

These rules specifically prohibit any agreement that would limit a customer's potential available counterparties. This prohibition encourages competition among SD counterparties for the customer's business, which is likely to reduce spreads and promote the customer's ability to obtain swap positions on terms approaching or equaling the best

[73] See e.g., AIMA, SIFMA, Vanguard, and MFA.

available terms in the market at that time. Accordingly, the Commission expects the spreads and terms under which customers are able to obtain swaps to improve when compared with a situation in which customers' range of potential counterparties is constrained by counterparty-specific sub-limits established by the FCM. It is possible that the effect of greater competition on spreads and terms may be mitigated by the impact of increased risk to the dealers, which is also likely to impact spreads and terms. However, the Commission believes that the latter effects will be minimized and diminish over time as the processing of trades becomes more rapid.

As suggested above, counterparty-specific sub-limits increase expenses related to monitoring and administrative requirements, and commenters have stated that in some circumstances trilateral agreements may actually slow swap processing. The prohibitions contained in these rules will prevent such arrangements, thereby leading to greater swap processing speed in those circumstances.

c. Price Discovery

If certain customers are prevented from accessing swaps on terms that approximate the best available terms in the market at that time, and then the terms of that trade are reported in real time, it risks sending misleading signals to the market about the price at which certain swaps are available. This result has the potential to undermine price discovery. The prohibitions in these rules will help ensure that customers in the market can access trades on approximately the best terms available in the market, both in general by prohibiting agreements that would prevent such an outcome, and more specifically by prohibiting any (1) agreements that would limit the number of counterparties with whom

a customer may trade, and (2) counterparty-specific sub-limits on the customer's positions.

d. Sound Risk Management Practices

By ensuring that customers are able to trade with all willing counterparties in the market, the rules promote greater liquidity available to the customer and to potential counterparties, which makes it more likely they will be able to enter swaps and offset positions as needed. This result is important for maintaining effective offsetting positions as underlying positions change. Moreover, greater liquidity may push transaction costs downward, which enables market participants to execute their risk management strategies in a more cost-effective manner.

To the extent that prohibiting certain terms typical of trilateral agreements will reduce an SD'scertainty about whether the swap will be cleared, it may increase the SD's risk management costs. However, as noted above, trilateral agreements did not appear until June 2011, which suggests that SDs are capable of managing their risks effectively in the absence of certain terms contained in those agreements. For example, SDs conduct due diligence in order to evaluate their counterparty's credit-worthiness, and may choose to negotiate terms in the bilateral agreement that determine what obligations each counterparty has in the event that a swap should be rejected from clearing. SDs may have to adjust their risk management strategies for the possibility that their counterparty may not be able to meet the terms of the bilateral agreement if the trade is rejected. If such bilateral agreements provide that the swap will be terminated when rejected from clearing, the dealer may have to unwind or offset certain aspects of positions that they have taken to offset the original position. The Commission anticipates that SDs will

account for these potential additional costs in the terms and pricing of the swaps they offer. In most cases, however, the risk management strategies described above reflect current market practice. Therefore, much of the costs associated with those practices are not a function of these rules. Last, these potential costs will be mitigated by faster processing, and, in cases where prescreening or near real-time post-execution screening are possible, eliminated.[74]

Some SDs have posited that market liquidity for some customers may decrease because SDs will not provide swaps to counterparties whose credit quality is lower unless a trilateral agreement is executed. The Commission recognizes that any factor that undermines SDs' confidence that swaps will be cleared may cause them to avoid certain trades or to increase the price at which they are willing to offer swaps to certain counterparties. However, because SDs have been providing liquidity to market participants for years in the absence of trilateral agreements, and adoption of such agreements is not yet widespread, the Commission does not believe that preventing certain provisions of these agreements will significantly reduce liquidity in swap markets. Moreover, certain aspects of these rules, such as requirements for rapid swap processing and clearing determinations, are likely to promote additional liquidity by reducing the counterparty risk that could develop for SDs between the time of execution and clearing.[75]

e. Other Public Interest Considerations

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[74] Several commenters pointed out that in an environment where real-time clearing determinations are made, bilateral execution agreements are not necessary. As evidence, commenters pointed to Clearport, Globex, and WebICE. Each of these platforms facilitate real-time clearing determinations, and each does so without bilateral execution agreements. See e.g., SDMA and Javelin.

[75] See section 2, Timing of Acceptance of Trades for Clearing, below.

The Commission has not identified additional public interest considerations beyond those discussed above.

f. Response to Comments

Several commenters noted that the benefits of the proposed rules include: reduced systemic risk;[76] reduced barriers to entry and greater competition among liquidity providers, clearing members, and execution venues;[77] enhanced market depth and liquidity;[78] substantially reduced transaction costs;[79] narrower bid-ask spreads;[80] and increased access to best execution via the freedom to execute with any counterparty in the market.[81] D. E. Shaw and MFA commented that the proposed rules would preserve anonymity among trading participants, and facilitate the development of electronic trading and central limit order books.

Additionally, several commenters remarked that without the final rules, the framework for trilateral agreements would substantially increase costs for market participants.[82] AllianceBernstein suggested that without the proposed rules, resources would be diverted from forward-looking technological solutions for clearing certainty, and instead used to prop-up legacy systems for credit intermediation.[83] Vanguard stated that the trilateral agreement will introduce significant costs and delays to the timeline for swaps clearing implementation because parties will be forced to execute a myriad of documents as a pre-condition to clearing and trading.

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[76] See AllianceBernstein, Arbor, CBA, CIEBA, Citadel, D. E. Shaw, and MFA.
[77] See AllianceBernstein, Arbor, Citadel, D. E. Shaw, and MFA.
[78] Id.
[79] See AllianceBernstein, Arbor, and CIEBA.
[80] See AllianceBernstein, Citadel, D. E. Shaw, and MFA.
[81] See AllianceBernstein, Citadel, D. E. Shaw, and MFA.
[82] See AllianceBernstein, Citadel, D. E. Shaw, MFA, SIFMA, and Vanguard.
[83] See also MFA, Citadel.

Moreover, multiple commenters stated that while they are generally loathe to encourage regulations that interfere with private contracts between two parties, they believe that the undesirable consequences of trilateral agreements, such as limiting a customer's choice of counterparties and trading venues, impairing their access to the best terms available, the potential for anticompetitive effects, creating barriers to entry for new liquidity providers, delaying adoption of technology that will enable real time processing and clearing determinations, and precluding anonymity that is a necessary condition for trading on central limit order books, justify these rules.[84] In this vein commenters maintained that the largest SDs have sufficient power deriving from their role as swap liquidity providers to coerce at least some market participants into signing "optional" trilateral agreements, and expressed concern that the agreement could rapidly become an industry standard despite the resistance of buy-side firms.[85] The Commission agrees that it is necessary, in this case, to establish rules that prevent trilateral agreements from being used to limit open and competitive swap markets.

In supporting the use of trilateral agreements some commenters have suggested that they are analogous to the FIA/FOA sponsored International Uniform Brokerage Execution Services ("Give-Up") Agreement ("Futures Give-Up Agreement"), which is used in the futures markets. The Futures Give-Up Agreement is between an executing broker, clearing broker, and customer, and allows the clearing broker to "place limits or conditions on the positions it will accept for the give-up for customer's account."[86] Commenters expressed the opinion that the risks faced by executing brokers and clearing firms in futures markets are substantially similar to the risks faced by SDs and clearing

[84] See SDMA, AIMA, Trading Firms, MFA, Arbor, DRW, and Jeffries.
[85] See AIMA, Trading Firms, CIEBA, Citadel.
[86] See Morgan Stanley, FIA/ISDA, Banks.

members in the swap markets, and therefore the use of trilateral agreements should be acceptable.[87]

However, the Commission is not persuaded that the points of similarity between Futures Give-Up Agreements and trilateral agreements provide sufficient evidence to demonstrate that the latter may be used in swap markets without adverse effects on market participants as discussed above. The two types of agreements are distinguishable in important respects. The parties to a Futures Give-Up Agreement include a customer and two brokers acting on behalf of the customer. The parties do not include the customer's trading counterparty in the relevant transaction. Moreover, Futures Give-Up Agreements do not: (a) disclose the identity of a customer's original executing counterparty to any FCM, SD, or MSP; (b) limit the number of counterparties with whom a customer may trade; (c) restrict the size of a position that the customer may take with any individual counterparty apart from the overall limit for all positions held by the customer at the FCM; (d) limit a customer's access to execution of trades on terms that have a reasonable relationship to the best terms available; or (e) prevent compliance with other regulations requiring rapid processing and acceptance or rejection from clearing.

Some commenters suggested that by specifying the types, size, and volume of trades that they are willing to engage in with certain customers, trilateral agreements help increase the range of counterparties with whom SDs are willing to trade.[88] There is not sufficient data available to the Commission to evaluate these assertions, and commenters did not provide any data to support them. The Commission acknowledges that factors reducing an SD's certainty about whether a swap will be cleared could prompt it to limit

[87] See Morgan Stanley.
[88] See Morgan Stanley, UBS, and EEI.

its business with certain counterparties or to change the terms under which it offers swaps to certain counterparties, but the trilateral agreements could also constrain either the range of counterparties with whom an SD is willing to trade, the size of positions it is willing to offer to certain counterparties, or both.[89] In other words, while some commenters are concerned that prohibiting certain terms in trilateral agreements may constrain liquidity, the Commission recognizes that trilateral agreements also constrain liquidity. It is not knowable at this time which force is likely to have the greater constrictive effect on the liquidity that an SD is willing to provide to certain counterparties. Moreover, as stated above, some aspects of these rules, including the straight-through-processing and risk management provisions, are likely to substantially reduce, if not eliminate, SD latency exposure and encourage SDs to provide greater liquidity. Accordingly, in the Commission's judgment, proscribing certain terms of trilateral agreements (with their negative implications for competition, efficiency and price discovery) is the preferable approach from a systemic standpoint to promote liquidity.

Commenters opposed to the rules stated that prohibiting trilateral agreements would require buy-side and sell-side firms to subject themselves to risks that they do not face today and would make it necessary for dealers to expend resources negotiating bilateral agreements with customers and evaluating the customer's credit prior to executing a transaction.[90] However, this would only be true to the extent that trilateral agreements

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[89] The first page of the FIA-ISDA Cleared Derivatives Execution Agreement states that "EXECUTION PARTIES MAY REQUEST THAT A FORM OF THIS AGREEMENT (OR THE ANNEXES HERETO) BE EXECUTED AS A CONDITION TO ENTERING INTO TRANSACTIONS INTENDED TO BE CLEARED." See http://www.futuresindustry.org/downloads/ClearedDerivativesExecutionAgreement_June142001.pdf.

[90] See Banks, Morgan Stanley.

are (1) being used today to mitigate certain risks, and (2) make it unnecessary to negotiate bilateral agreements and evaluate a customer's counterparty risk. As stated above, the Commission believes that trilateral agreements are not widely used at this time and, thus, are providing dealers risk protection only to a limited extent. Moreover, it does not appear that trilateral agreements obviate the need to negotiate what might happen in the event of breakage; the Commission, therefore, does not believe that prohibiting certain provisions of trilateral agreements is likely to significantly impact the expenses associated with bilateral agreements.[91]

Furthermore, commenters opposed to the rules stressed that the trilateral agreements are optional.[92] They also noted that the trilateral agreements "do not affirmatively limit" a customer's ability to trade with willing counterparties or prohibit dealers and customers from entering positions greater than the sub-limit established by the FCM.[93] However, even in the absence of "affirmative" limitations, the agreement may have much the same effect. Some commenters stated that certain dealers have expressed unwillingness to continue providing swaps to certain customers if they did not sign a trilateral agreement; the agreement itself contemplates this possibility.[94] The Commission's concern with conduct of this type is heightened by information suggesting that a relatively small number of dealers provide a significant amount of swap liquidity available.[95] Under

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[91] See http://www.futuresindustry.org/downloads/ClearedDerivativesExecutionAgreement_June142001.pdf. The trilateral agreement template includes terms dictating what happens in the event that a swap is rejected from clearing. The CFTC believes, therefore, that these terms are likely negotiated and addressed even where trilateral agreements are used.

[92] See FIA/ISDA.

[93] See Morgan Stanley. See also FIA/ISDA, Banks.

[94] See n.71, above.

[95] See the OCC's Quarterly Report on Bank Trading and Derivatives Activities Third Quarter 2011, available at http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/dq311.pdf, which states, "Derivatives activity in the U.S. banking system continues to be dominated by a small group

these circumstances, each dealer that refuses to offer swaps in the absence of a trilateral agreement may significantly reduce liquidity available to a customer. Absent sufficient competition to provide liquidity, dealers may be able to impose restrictive, undesirable trilateral agreement terms on customers.

Commenters in favor of trilateral agreements suggested that concern about anti-competitive behavior could be addressed by allowing the customer to determine how their overall limit at the clearinghouse is allocated across potential counterparties. The Commission agrees that such an approach would mitigate the concern that FCMs could use trilateral agreements to influence a customer's choice of counterparties in an anti-competitive manner. However, it would not allow customers to take positions in excess of previously established sub-limits with certain counterparties without walking through the process of reallocating sub-limits, a process that could be time consuming. This result risks delay of swap processing and clearing determinations, or inducement of market participants to select suboptimal offers that comply with pre-established limits to avoid the delay. Such a delay could be particularly problematic in volatile market situations, where the ability to enter into positions quickly may be necessary in order to manage risk effectively.

2. Timing of Acceptance of Trades for Clearing

Taken as a whole, the regulations in this cluster require SEFs, DCMs, SDs, MSPs, and DCOs to coordinate in order to facilitate real-time acceptance or rejection of trades for clearing, including through development of the technology necessary to do so. In the

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of large financial institutions. Five large commercial banks represent 96% of the total banking industry notional amounts and 85% of industry net current credit exposure." While the report only includes data related to positions held by U.S. banks, and incorporates derivatives that are not swaps, anecdotal evidence also supports the likelihood that a relatively small dealer population accounts for significant portions of swap liquidity.

case of cleared trades, the swaps must be processed and submitted to the DCO as soon as technologically practicable using fully automated systems. In the case of non-cleared trades, the swaps will be processed and submitted to the DCO as soon as is technologically practicable, but allows for processing to take slightly longer. More specifically:

Regarding Clearing Members

Sections 1.74 and 23.610 require that FCMs, and SDs and MSPs, respectively, coordinate with the DCO to accept or reject trades for clearing "as quickly as would be technologically practicable if fully automated systems were used" and do so by one of the following methods: (1) pre-screening orders; (2) enabling the DCO to screen orders using criteria established by the FCM, SD or MSP; or (3) setting up systems that enable the DCO to communicate with and receive a reply from the FCM, SD, or MSP as soon as would be practicable if fully automated systems were used.

Section 23.506 requires SDs and MSPs to: (1) have the capacity to submit swaps that are not executed on a DCM or SEF ("OTC swaps") to the DCO for clearing in a way that is acceptable to the DCO; (2) work with the DCO to process swaps in a manner that is "prompt and efficient" and that complies with 39.12(b)(7); (3) submit bilateral swaps to the DCO as soon as is technologically practicable but no later, if it is a swap subject to mandatory clearing, than the close of business on the day of execution, or, if it is a swap not subject to mandatory clearing, no later than the end of the following business day from the later of execution or the date when the parties decide to clear.

Section 1.35 requires that for bunched trades that are cleared, post-trade allocations must occur on the day of execution, so that clearing records properly reflect the ultimate

customers. (Bunched trades that are cleared are not given a delay for post-trade allocation before being submitted for clearing.) For bunched trades that are not cleared, post-trade allocations must happen by the end of the day they are executed.

Regarding Execution Platforms

Section 38.601 requires that transactions executed on or through a DCM, other than transactions in security futures products, must be cleared on a DCO, and the DCM must work with DCOs to ensure "prompt and efficient" transaction processing such that the DCO can comply with § 39.12(b)(7). Section 37.702(b) requires that SEFs coordinate with DCOs in order to route transactions to the DCO in a manner acceptable to the DCO, and to develop rules and procedures that facilitate prompt transaction processing in accordance with § 39.12(b)(7).

Regarding DCOs

Section 39.12(b)(7) requires DCOs: (1) to coordinate with SEFs and DCMs to develop rules and procedures that facilitate "prompt, efficient, and accurate" processing of transactions received by the DCO; (2) to coordinate with FCMs, SDs, and MSPs to set up systems that enable the clearing member or the DCO acting on its behalf to accept or reject trades for clearing as swiftly as if fully automated systems were used; (3) for trades executed on SEFs or DCMs, to establish rules to accept or reject trades for clearing as fast as if fully automated systems were used, and to accept all trades for which both executing parties have a clearing member, and that satisfy the criteria of the DCO; and (4) for trades that are not executed on SEFs or DCMs, but that are for contracts listed by the DCO, to satisfy requirements similar to those applicable to trades that are executed on SEFs or DCMs.

a. Protection of Market Participants and the Public

The Commission anticipates that this group of rules will provide significant benefits to market participants. First, by requiring that SEFs, DCMs, SDs, and MSPs coordinate in ways that will lead to faster processing and acceptance or rejection of swaps for clearing, the rules reduce the latency period during which counterparty risk can accumulate for parties who have executed a swap that they intend to clear. If, following a long latency period, the swap is rejected from clearing and is cancelled as a consequence, the SD will be forced to recoup breakage costs from their counterparty to the extent that their bilateral agreement provides and their counterparty is able to meet the terms of that agreement; the SD also may need to unwind or offset any position it has established, potentially at a loss. SDs have pointed out that the size of many swap transactions, as well as the illiquidity and volatility of these markets, create the potential for these risks to be substantial,[96] so by reducing the time between execution and clearing, these rules provide considerable benefits to SDs. Moreover, for swaps where real-time acceptance or rejection from clearing occurs, the latency period, and the potential for post-execution termination costs, is eliminated.

Likewise, non-SD market participants will be able to better judge their counterparty risk and hedging strategies. The possibility exists that a non-SD market participant could have to unwind or offset other positions at a loss if a swap position is cancelled unexpectedly, or need to create the same position but on less favorable terms if the market has moved against them. It is also possible that the non-SD market participant may not be able to negotiate terms with the SD that would allow it to recoup much or all of the costs associated with the cancelled swap. Reducing or eliminating the latency

[96] SDs, however, did not provide estimates of or seek to quantify such risks.

period through more rapid processing and acceptance or rejection of swaps from clearing will reduce those costs to the benefit of both SD and non-SD market participants. If there is less time between execution and clearing, there will be less time for counterparty exposure to develop, which mitigates the need for extensive due diligence or for elaborate procedures to address breakage costs.

With respect to costs, some capital investment will be necessary to develop the processes and implement the technology necessary to meet the requirements specified in these rules. However, in the case of DCMs, SDs, MSPs, and DCOs, the Commission believes that many entities are already using procedures and technology that comply with the standards in some measure. The necessary investments, therefore, will be incremental and will depend significantly on the current processes and technology in place at each of these institutions. Moreover, many of these entities may have to modify or upgrade their systems in order to comply with other aspects of the Dodd-Frank Act. The costs necessary to adjust technology platforms to meet these other requirements are being considered in each of those rules, and so the costs attributable to these rules are only those that create improvements that would not otherwise be made pursuant to those other rules. The incremental costs attributable to these rules cannot be quantified, due to the flexibility the rules provide regulated entities to meet the applicable standards and to the differing technology already in use by those entities, but the Commission anticipates that the necessary capital expenditures by some entities may be significant. However, as discussed above, the benefits of such technology and procedures are substantial as well, and, based on comments, the Commission believes potentially of a magnitude to offset the costs of implementing such systems. Citadel believes the rules will save enough

resources to benefit the economy as a whole, and SDMA estimates that the total benefits for corporate America will have a value of approximately $15 billion annually.[97]

b. Efficiency, Competitiveness, and Financial Integrity of the Markets

The general requirement that processing and acceptance or rejection from clearing must occur "as quickly as is technologically practicable" or "as quickly as is technologically practicable if fully automated systems are used" creates an enforceable standard that provides SEFs, DCMs, SDs, MSPs, and DCOs the freedom to establish systems that meet their unique operational needs and that is, in their judgment, most cost effective. By accommodating innovation, and further system improvements, this approach will promote continued improvements in the reliability and efficiency of these systems that, indirectly, may benefit financial market efficiency generally.

Rapid processing and acceptance or rejection from clearing will help to ensure that eligible counterparties are not exposed in transactions that are ultimately rejected from clearing and broken. With respect to dealers, this helps to ensure that they will be available to other eligible customers by reducing the amount of their balance sheet that is "tied up" supporting transactions that are eventually rejected from clearing and broken. By limiting the duration of transactional exposure, the rules' rapid processing requirements serve to help protect market liquidity that dealers in significant part provide.[98]

Required coordination among SEFs, DCMs, SDs, MSPs, and DCOs, together with the requirements for rapid processing and acceptance or rejection from clearing, is likely to

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[97] See Citadel and SDMA. Neither commenter provided calculations to substantiate their estimates, so the Commission is not able to verify their accuracy. However, as stated above, the Commission does believe that the benefits of such systems and procedures will be substantial.

[98] See n. 77, above.

promote broad adoption of standardized technologies and processes. The rules, in this respect, will provide an incentive to further improvements in the speed of processing, and may reduce switching costs for customers by ensuring that their technology platforms are able to interface with a wide array of FCMs and counterparties without significant modifications. Lower switching costs, in turn, are conducive to greater competition among SD counterparties and lower bid-ask spreads may result.

Limit order books[99] cannot exist in an environment where there is uncertainty about clearing because each participant will want to identify its potential counterparty and evaluate its creditworthiness in order to manage risks that could develop if the trade is rejected from clearing. Enabling clearing members and exchanges to pre-screen orders in real time for compliance with clearing member limits for each customer facilitates the development of a central limit order book and the pure price competition it affords by ensuring that each trade executed on the exchange will proceed to clearing. This certainty, and the central limit order book that it makes possible, enables anonymous, exchange-based execution. This execution method is an effective mechanism for providing all-to-all market access, placing all eligible market participants on equal footing when bidding on or offering positions; the only distinguishing characteristic among them is the price they bid or offer. Participants do not need to know the identity of entities on the other side of the trade or to concern themselves with the creditworthiness of those entities because each participant knows they will be facing the clearinghouse as their counterparty.

[99] A Central Limit Order Book (CLOB) is a system used by many exchanges to consolidate and match orders. An open CLOB exposes available pricing and market depth for listed products. Market participants are allowed to see limit orders that have been placed but have not yet been executed or cancelled. Usually, exchanges use open CLOBs to match customer trade orders with a "price time priority."

Efficiency, certainty of clearing, and liquidity in the U.S. based swap markets are attractive characteristics that may prompt additional customers and dealers to send business to U.S.-based exchanges. To the extent that this occurs, it will promote greater liquidity and competition.

c. Price Discovery

Pre-trade price transparency is enhanced by central limit order books, where market participants can view the prices at which market participants are willing to "buy" or "sell" certain positions. Pre-screening capabilities help to ensure that only bids and offers from parties whose transactions will be accepted for clearing are represented in the central limit order book. This promotes the integrity of the order book, and the informational value of the bids and offers contained within it, which promotes effective price discovery.

To the extent that a swap moves from execution to acceptance or rejection from clearing and receives an answer in real time that speed eliminates the need for SDs to price idiosyncratic counterparty risk (i.e. risk that is different than that posed by the clearinghouse as a counterparty) into the swap. This result means that the price at which a swap is transacted more accurately reflects the price that other market participants would receive for the same product at that time. Therefore, the prices reported in real time have greater informational value for all market participants.

d. Sound Risk Management Practices

If an SD is uncertain whether a trade will clear, it will not know whether it should account for idiosyncratic counterparty risk because it will not know whether the

clearinghouse or their counterparty will face them for the life of the swap.[100] Or, if the agreement between the SD and the customer counterparty calls for the trade to be cancelled in the event of clearing rejection, the SD's hedging strategies will be complicated by uncertainty until the clearing outcome is known. Faster processing and acceptance or rejection of trades from clearing facilitates sound risk management by eliminating these uncertainties, or at least by reducing the period of time during which they are relevant. This result makes it easier and potentially less costly for dealers to develop and execute sound risk management strategies.

Similarly, faster processing and acceptance or rejection from clearing makes it easier and potentially less costly for other non-SD market participants to manage their risk effectively. The more certainty SDs have that a trade will clear, the less they need to charge for clearing-acceptance risk. This result makes it less expensive for non-SD market participants to acquire the positions they need to execute their risk management strategies. It also obviates the need that an SD would otherwise have to evaluate counterparty credit-worthiness, which may decrease the amount of time required for a market participant to execute a needed trade. In volatile markets, this increased speed can be valuable, if not essential, when managing complex risks.

On the other hand, some processes will still be manual even after these rules are adopted. This result may be true particularly for swap transactions that are executed bilaterally and then communicated to clearing members. Speed requirements may increase the possibility of errors in manual processes. The potential range of mistakes and range of costs associated with those mistakes is broad, and impossible to estimate. However, market participants have an incentive to avoid such mistakes, and the

[100] See DB.

Commission anticipates that the requirements related to the timing of acceptance or rejection from clearing will encourage automated, straight-through processing, which over time is likely to reduce the number of manual processes and therefore the number of opportunities for errors.

Also, while these rules require clearing members, SEFs, DCMs, and DCOs to develop the ability to process swaps and make clearing determinations in a timeframe that is likely to be a matter of milliseconds, seconds, or at most, a few minutes, bilateral transactions will still take some amount of time to submit to the appropriate clearing member. The rules require SDs and MSPs to submit OTC swaps for clearing as soon as is technologically practicable and in no case later than the close of business on the date of execution for swaps that are required to be cleared, and in no case later than the end of the business day following execution or the decision to clear (whichever is later) for swaps that are not required to be cleared. Moreover, until the mandatory clearing regime becomes effective, all OTC swaps will be subject to the requirement that they be submitted for clearing as soon as is technologically practicable but in no case later than the day following execution or the decision to clear (whichever is later). Therefore, some time lapse between execution and clearing as well as some breakage risk will remain for OTC swaps and that risk may be greater prior to the mandatory clearing regime becoming effective.

However, the Commission notes that these rules establish timelines for submission to clearing that are considerably shorter than what some market participants practice today. Moreover, the close of business on the date of execution and the end of the business day following execution or the decision to clear (whichever is later) are outer bounds on the

timeline for submitting swaps to clearing. The rules still require these swaps to be submitted "as soon as is technologically practicable," which in many cases will likely be sooner than these outer limits. Last, to the extent that market participants bear breakage cost risk, they have an incentive to submit OTC swaps for clearing promptly and to implement and promote technological improvements that will allow them to do so. Each of these considerations are likely to significantly reduce the amount of time between execution and submission for clearing for OTC swaps, and therefore, are likely to mitigate the breakage risks that counterparties face when engaging in OTC transactions.

e. Other Public Interest Considerations

As described above, rapid and predictable clearing provides substantial benefits for both SDs and other market participants. As market entities come into compliance with these rules, the Commission anticipates that rapid processing and clearing determinations will make the U.S. markets more attractive to foreign entities, which could further increase liquidity and reduce spreads.

Also, the Commission observes that much of the technology that will be necessary to meet these requirements has been implemented in certain venues with marked success.[101] This circumstance, together with the fact that many market participants already may have systems capable of at least partial compliance, will serve to limit the overall outlay necessary to bring regulated entities into compliance.

f. Response to Comments

Many commenters agreed that the technology for real time acceptance or rejection already exists in other cleared derivatives markets and is currently being rolled out for

[101] See e.g., Arbor, Eris, CME, SDMA, Vanguard, and Javelin.

cleared OTC swaps.[102] Commenters also noted that the benefits of the rules far exceed any incremental costs in upgrading infrastructure, and that any required infrastructure upgrades would be minimal due to existing industry capabilities.[103] Furthermore, Citadel stated that any costs to upgrade existing infrastructure have already been factored into industry investment plans, because many SDs, FCMs, DCOs, and SEFs are already launching real-time acceptance.

Eris noted that it is currently able to execute and clear interest rate swaps. Arbor stated that it supports both the Globex and Clearport solutions for swaps because they are proven, work well, and would be inexpensive alternatives for market participants to implement. Arbor continued to state that because such workflow and technology are currently used by clearinghouses and clearing members today, these technologies could be ported quickly into the cleared swaps context. Finally, Arbor remarked that by compelling market adoption of workflow and systems currently deployed in other cleared markets, implementation will be less costly and more rapid.

Javelin calculated that Clearport's daily trade volume increased from 139,177 contracts in 2005 to over 450,000 contracts today. Javelin also noted that Clearport covers multiple asset classes including credit and interest rates, and is interfacing with over 16,000 registered users, and Globex had average daily volume of 6,368,000 contracts in interest rates during August 2011 and total exchange average daily volume of 14,420,000 contracts during the same period.

Commenters opposed to the rules doubted that "market-wide real-time" clearing and risk limit compliance verification can be developed quickly enough or provided with

[102] See AllianceBernstein, Arbor, Citadel, D. E. Shaw, Eris, Javelin, MFA, SDMA, and State Street.
[103] See AllianceBernstein, Arbor, D. E. Shaw, MFA, and SDMA.

sufficient reliability to eliminate the "functional benefits" of trilateral agreements.[104] One commenter posited that to provide real-time clearing on a broad basis would require systems that have the capacity to share information, calculate risk metrics on a portfolio basis, adjust limits accordingly, and disseminate information in ways that are not currently possible and that are unlikely to be possible in the near future.[105]

However, the Commission is not persuaded by these opposing commenters' arguments, which pivot on an assumption that the Commission's determination to prohibit certain provisions commonly contained in trilateral agreements is premised on a faulty belief that the functional benefits of trilateral agreements will be entirely eliminated in the near term. Such a belief, however, is not the premise for the Commission's determination. Rather, after careful consideration of costs and benefits associated with trilateral agreements, the Commission believes that certain provisions common to these agreements generate unacceptable costs and, thus, should be prohibited. In reaching this determination, the Commission has not concluded, and need not conclude, that the trilateral agreements, judged in isolation, are devoid of value.

Moreover, the Commission believes that significant improvements in straight through processing and in the speed of processing and clearing determinations can be achieved even when the ideal is not yet attainable. In that regard, the Commission notes that the system requirements delineated by commenters opposed to the rules describe "requirements" that the Commission does not believe are necessary to straight through processing or real time clearing determinations.[106] Several commenters noted that some technologies existing today provide near real-time clearing determinations with respect to

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[104] See Morgan Stanley, and Banks.
[105] See Morgan Stanley.
[106] Id.

certain swaps.[107] Those systems function effectively despite the fact that they do not achieve the ideal system requirements described by other commenters. The Commission, therefore, believes that while many of the "requirements" described by some commenters are desirable, they are not essential to swap processing and clearing determinations that comply with these rules. Furthermore, the Commission believes that improvements that significantly mitigate the risks associated with counterparty exposure that trilateral agreements seek to address are possible with existing technology.

One commenter suggested that sub-limits with individual dealers need not delay clearing of swaps because the same technology that is used to satisfy the Commission's requirements for clearing in real time could be used to automate the sub-limits.[108] However, commenters generally agreed that real-time clearing determinations would mitigate or eliminate any legitimate need for sub-limits or the agreements necessary to establish them, a perspective that the Commission finds persuasive.[109] Once the technology necessary for straight through processing and real time clearing determinations is in place, the economic rationale that commenters have advanced in favor of sub-limits will no longer be relevant, and therefore the elements of trilateral

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[107] See SDMA, Vanguard, State Street, Arbor, Eris, CME, and Javelin. Multiple commenters cited Clearport as an example of immediate post-trade (or "low latency") solution that is already providing clearing acceptance/rejection decisions within milliseconds of execution in some markets. Similarly, commenters cited Globex and WebICE as examples of platforms that provide pre-trade screens against customer limits set by FCMs, which enables "perfect settlement" (i.e. every trade that is executed is accepted immediately for clearing) for the markets in which they operate. Commenters generally cited these examples as evidence that the requisite technology for real time clearing determinations already exists, and could be applied more broadly in order to facilitate compliance with the rules adopted in this release.

[108] See Morgan Stanley.

[109] See e.g., SDMA, AIMA, Vanguard, AllianceBernstein, Trading Firms, and MFA.. In addition, Morgan Stanley, ISDA/FIA, Banks, and EEI implicitly acknowledge that real-time clearing determinations mitigate the need for trilateral agreements by arguing that trilateral agreements are a useful risk management tool because real-time clearing determinations are not yet possible in all parts of the market.

agreements that are prohibited in the first part of these rules will not assist SDs with risk management.

3. Clearing Member Risk Management

This cluster of rules establishes risk management requirements for FCMs, SDs, and MSPs who are clearing members. Section 1.73 of the Commission's regulations requires FCMs who are clearing members to: (1) establish limits for proprietary accounts and customer accounts based on position size, order size, margin requirements, etc.; (2) ensure that trades received by the FCM for automated or non-automated execution, that are executed bilaterally then delivered to the FCM, or that are executed by a broker and then delivered to the FCM, are screened by either the FCM or the broker (whichever encounters the transaction first) for compliance with overall position limits at the FCM for each customer; (3) monitor for compliance with overall position limits at the FCM for each customer both intraday and overnight; (4) conduct stringent stress tests for all positions that could impact its financial strength at least once per week; (5) evaluate its ability to meet initial margin requirements at least once per week; (6) evaluate its ability to, and the cost of, liquidating positions in its proprietary and customer accounts at least once per month; (7) test all lines of credit at least once per year; and (8) establish procedures and maintain records to ensure and document compliance with these requirements.

Section 23.609 requires SDs and MSPs who are clearing members to do all the same things to manage risk, with the exception that bilateral execution, "give up" agreements, and bunched orders are not addressed in this section, because SDs and MSPs may only clear customer trades if they are also registered as FCMs.

a. Protection of Market Participants

Several reported incidents over the last 15 years involving so called "rogue traders"[110] highlight the protective import of these rules. The rules in the second group require FCMs to establish overall position limits for each of their customers and promote the establishment of systems capable of more effectively pre-screening orders for compliance with these overall position limits. Automated screening mechanisms that are external to those of an FCM's customer provide a second layer of defense against evasion by rogue traders within the customer's organization. The Commission believes that these measures will help protect against rogue trading, thereby protecting market participants, who past events have shown to be vulnerable to harm from such conduct.[111]

With respect to the risk management requirement that each clearing member establish overall position limits for each customer, the rules promote restrictions that help prevent individual customers from establishing positions sufficiently large to jeopardize the financial health of their clearing member if they were to default. This is a critical safeguard that, due to its importance and relative simplicity, the Commission anticipates many clearing members may already have in place. But, by implementing these rules, the Commission is ensuring that every clearing member uses such safeguards to help ensure that they, and the DCOs on which they clear trades, remain financially sound even during times of financial market turbulence.

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[110] See e.g., Report of the Board of Banking Supervision Inquiry Into the Circumstances of the Collapse of Barings, (Jul. 18, 1995), available at: http://www.prmia.org/pdf/Case_Studies/Barings_Case_Study.pdf; Factbox: Rise and Fall of the SocGen Rogue Trader, Reuters (Jan. 27, 2008), available at http://www.reuters.com/article/2008/01/27/us-socgen-factbox-idUSL2733740320080127.

[111] A key purpose of risk management procedures is to minimize the chance of a firm incurring losses that exceed its risk appetite. For example, in 1999, a CFTC-regulated futures commission merchant filed bankruptcy after a trader exceeded his trading limits. This event highlights the potential damage that occurs from a poorly designed risk management program or from a lack internal controls.

The risk management requirements do prescribe certain timelines for regular testing and evaluation; however, they do not dictate (1) specific levels for position limits set by clearing members, or (2) specific methodologies of testing with respect to the clearing member's ability to meet margin requirements, the cost of liquidating positions, or stress testing positions that could have a material impact on the entity's financial strength. This flexibility gives market participants the opportunity to implement the requirements in ways that are suited to their operational patterns and minimize costs associated with changes and upgrades to existing technology systems. Moreover, it allows market participants ample room to innovate and adapt the most effective procedures as the market continues to evolve. This flexibility for innovation and adaptation is critical to the long term success of risk management practices. Over time the markets will continue to evolve with changes in products, connections among institutions, regulatory requirements, and broader economic realities. Each of these dynamic realities has the potential to impact the effectiveness of specific risk management strategies, making it essential for firms to continue adapting their approaches. The rules benefit FCMs, their counterparties, and the public by giving FCMs the flexibility they need to continue developing effective risk management strategies that address current market realities.

Clearing members that do not currently practice one or more of the requirements established by this cluster of rules will incur some incremental costs to comply with them. Some initial investment will be required to develop and implement processes necessary for compliance, and ongoing costs will be incurred as such entities engage in repeated testing. The incremental cost for each entity will depend on the degree to which its current practices are or are not in compliance, as well as the procedures they select and

implement in order to comply. The Commission does not have, and has not been provided by commenters with, the information required to estimate those costs either on a per-entity or aggregate basis. However, the Commission expects that while the costs may be material for a small number of entities, most clearing members are currently using risk management strategies that are largely compliant with these requirements and, therefore, the incremental cost for most entities and for the market as a whole is likely to be relatively low.

b. Efficiency, Competitiveness, and Financial Integrity of the Markets

With clearing mandates in place, the financial integrity of swap markets will depend significantly on the financial strength of DCOs. Moreover, the financial health of a DCO is dependent upon the strength of its clearing members and those members' ability to meet any obligations pursuant to the terms of their agreement with the DCO. By requiring clearing members to implement sound risk management practices, the rules mitigate the risk that those members could experience financial strain that could undermine the financial strength of the DCO.

In addition, by requiring that DCOs coordinate with clearing members and that clearing members coordinate with account managers who execute trades before submitting them to the clearing member, the rules promote market integrity by making it more difficult for market participants to circumvent the overall position limit established by their clearing member.

c. Price Discovery

The Commission does not expect these rules to materially affect price discovery.

d. Sound Risk Management Practices

As mentioned above, prescreening of trades for compliance with overall position limits set by the clearing member will help guard against the activities of rogue traders, particularly those that may be operating within one of the clearing members' customers. Intraday and overnight monitoring of compliance with overall position limits is an additional line of defense against the same risk, but also serves to help protect the clearing member against any such activities within its own ranks. In this way, the rules mandate processes that provide a deterrent against and a screen for rogue trading, and help to protect market participants from these relatively infrequent, but potentially catastrophic, risks.

Moreover, in situations where automated screening may not be possible, such as with bunched trades and give-up trades, the rules still specify requirements that should effect pre-screening of trades against overall position limits with the clearing member. Non-automated systems may be slightly slower, but the manual screens still provide some measure of protection against the activities of rogue traders. Even in situations where non-automated screening occurs post-execution, as is the case with screens on floor traders, manual systems—if carefully and rigorously practiced—can provide effective protection against excessive exposure. In the case of floor traders, the clearing member may monitor the trader's positions throughout the day and intervene in person when the trader exceeds allowable limits, forcing him to close out positions immediately in order to come under such limits, even if he must close out those positions at a loss. Such monitoring reduces the opportunity that the trader has to exceed appropriate limits, and the amount of time that such excesses can last, thus limiting the associated potential risk for his firm and the clearing member.

Also, as stated above, the flexibility that is implicit in these requirements is particularly critical as a precondition to innovation regarding testing methodologies. Clearing members might develop many different approaches to stress tests, one or more of which may be particularly well suited to a particular firm and set of market conditions, but which may not be well suited to other firms and market conditions. Flexibility is critical to enabling continued development and testing of new methodologies. It is likely to benefit the individual entities that engage in such innovation and testing, as well as a broader array of market participants introduced to developments at industry gatherings and through informal transfer of intellectual capital as personnel move between firms.

The requirement for each clearing member to evaluate its ability to meet margin requirements at least once per week is a valuable tool to help clearing firms avoid liquidity crises, which could jeopardize the solvency of otherwise healthy clearing members. Margin calls can come as a result of significant movements in the price of the underlying commodity, or as a consequence of changes in price volatility. Counterparties may choose to exercise options at unanticipated times, which may have significant repercussions for a clearing member's margin requirements. Additionally, a clearing member's cash position may be negatively impacted if one of its customers becomes unable to meet margin calls on large positions. Clearing members must have sufficient liquidity to meet margin calls from the DCO, even at a time when the clearing member may have a depleted cash position due to the failure of its customers to meet margin requirements. Such stress tests may help to ensure that the clearing member has a clear sense for how much liquidity may be necessary in such circumstances, and may encourage them to preserve ample liquidity.

Testing lines of credit also helps clearing members to ensure that (1) the credit provider is able to honor its commitment, and (2) the clearing member can access the line in a timely fashion. Liquidity crises seldom play out in slow motion, and time is likely to be of the essence when a clearing member needs to access its credit line. Therefore, it is important for the clearing member's staff to know how to access the line quickly and reliably when it is needed. By requiring annual testing, the rules guard against the danger that an episode of financial strain for the member could be exacerbated by an inability to access its credit line in a timely manner. Such preventable problems could be fatal for the firm in the midst of a liquidity crisis.

e. Other Public Interest Considerations

The Commission understands that the past several years' events in the financial markets have tested and strained the public's confidence in financial institutions' management of risks. To the extent that these regulations promote broader implementation of sound risk-management practices, they may serve to strengthen such public confidence in the integrity of the affected markets. Such public confidence, if justified by improved risk-management practices, is critical to the overall health and functioning of the swaps and commodity markets.

To the extent that sound risk management practices are broadened, these regulations will help to promote such confidence, and as such will benefit the financial markets and the American public who ultimately benefits from the health of these markets.

f. Response to comments

Chris Barnard and Better Markets both recommend that the Commission require specific stress tests. and FHLB recommends that stress test results be publicly

disclosed.[112] FHLB believes that public disclosure of stress test results would allow customers to mitigate risk.

The purpose of stress tests is for clearing members to monitor the potential losses they would face in the event of extreme market events as well as their ability to absorb such losses.

The Commission has chosen not to set specific thresholds or specifying methodologies for stress tests for three reasons. First, appropriate thresholds and methodologies depend, at least in part, on the types of customers and positions that characterize each clearing member's business. The clearing member is best positioned to account for these factors when developing an appropriate test. Second, the Commission believes that specifying certain stress test thresholds could prompt firms to focus tests on those minimum levels in order to meet regulatory requirements rather than establishing thresholds that further achieve the goal of maintaining a vigorous risk management program. Third, the Commission believes that specifying particular methodologies for stress testing would stifle innovation, which would undermine the effectiveness of stress testsas the swap markets and their clearing members continue to evolve.[113]

The Commission considered FHLB's recommendation but believes that public disclosure of stress test results could be a disincentive to aggressive stress testing, which would undermine the intent of this rule and the strength of the FCM's risk management program, and in so doing, increase risk to the DCO. Moreover, disclosure of results could have the effect of improper disclosure of confidential position information. Last,

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[112] See section IV.B(2)(a), above.

[113] The Commission also notes that the approach taken in this rule is consistent with the approach recently adopted by the Commission for DCO stress tests. The Commission intends to monitor to determine whether the tests conducted by clearing members are reasonably designed for the types of risk the clearing members and their customers face.

additional rules have been enacted limiting the range of assets in which FCMs can invest customer funds,[114] and requiring careful segregation of customer funds,[115] both of which are designed to protect customers in the event that an FCM should become insolvent. With these considerations in view, the Commission has chosen not to require FCMs to make the results of their stress tests public.

The CME commented that clearing members should only be required to test lines of credit on an annual basis rather than a quarterly basis Because they believe that more frequent testing is not cost efficient. ISDA inquired as to whether an institution must actually draw funds in order to properly test a line of credit.

The Commission agrees that quarterly testing might not be cost efficient in every situation, and therefore has established an annual testing requirement in the Adopting Release. However, the Commission encourages clearing members to test lines of credit more frequently based on any developments that might impact the ability of the lender to provide the line of credit, or the clearing member's ability to access it in a timely manner. Various market events, credit events, and operational changes could lead to a situation where testing lines of credit would be appropriate. For example, if , the clearing member changes personnel or reorganizes in a manner that changes the individuals who would be responsible for accessing the credit line, the Commission believes that it would be beneficial to test lines of credit.

The Commission believes that the actual drawing of funds is essential to testing a line of credit. Among other things, the test should ensure the ability of the bank or other

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[114] See Investment of Customer Funds and Funds Held in an Account for Foreign Futures and Foreign Options Transactions, 76 FR 78776 (Dec. 19, 2011).
[115] See Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions, 77 FR 6336 (Feb. 7, 2012).

institution to move the funds in a timely fashion, which is likely to be particularly important at times when the firm most needs the additional liquidity provided by the line of credit.

VII. Related Matters

A. Regulatory Flexibility Act

The Regulatory Flexibility Act ("RFA") requires that agencies consider whether the regulations they propose will have a significant economic impact on a substantial number of small entities.[116] The final rules set forth in this release would affect FCMs, SDs, MSPs, DCOs, DCMs, and SEFs. The Commission has already established certain definitions of "small entities" to be used in evaluating the impact of its rules on such entities in accordance with the RFA.

In the Commission's "Policy Statement and Establishment of Definitions of 'Small Entities' for Purposes of the Regulatory Flexibility Act,"[117] the Commission concluded that registered FCMs should not be considered to be small entities for purposes of the RFA. The Commission's determination in this regard was based, in part, upon the obligation of registered FCMs to meet the capital requirements established by the Commission. Likewise, the Commission determined "that, for the basic purpose of protection of the financial integrity of futures trading, Commission regulations can make no size distinction among registered FCMs."[118] Thus, with respect to registered FCMs, the Commission believes that the final rules will not have a significant economic impact on a substantial number of small entities.

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[116] 5 U.S.C. 601 et seq.
[117] 47 FR 18618 (Apr. 30, 1982).
[118] Id. at 18619.

Like FCMs, SDs will be subject to minimum capital and margin requirements, and are expected to comprise the largest global firms. Moreover, the Commission is required to exempt from designation as an SD any entity that engages in a de minimis level of swaps dealing in connection with transactions with or on behalf of customers. Based, in part, on that rationale, the Commission previously has determined that SDs should not be considered to be "small entities" for purposes of the RFA.[119] Thus, with respect to SDs, the Commission believes that the final rules will not have a significant economic impact on a substantial number of small entities.

Further, the Commission previously has determined that large traders are not "small entities" for RFA purposes, with the Commission considering the size of a trader's position to be the only appropriate test for the purpose of large trader reporting. The Commission similarly has noted that MSPs, by definition, will maintain substantial positions in swaps, creating substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets. Based, in part, on those facts, the Commission previously has determined that MSPs should not be considered to be "small entities" for purposes of the RFA.[120] Thus, with respect to MSPs, the Commission believes that the final rules will not have a significant economic impact on a substantial number of small entities.[121]

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[119] See "Registration of Swap Dealers and Major Swap Participants," 77 FR 2613, 2620 (Jan. 19, 2012); "Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties," 77 FR 9734, 9803-04 (Feb. 17, 2012).

[120] Id.

[121] In a recent rulemaking, the Commission discussed the applicability of the RFA with respect to SDs and MSPs as follows: "The Commission is carrying out Congressional mandates by proposing these rules. The Commission is incorporating registration of SDs and MSPs into the existing registration structure applicable to other registrants. In so doing, the Commission has attempted to accomplish registration of SDs and MSPs in the manner that is least disruptive to ongoing business and most efficient and expeditious, consistent with the public interest, and accordingly believes that these registration rules will not present a significant economic burden on any entity subject thereto." "Swap Dealer and Major Swap

Certain of the final rules set forth in this release will affect DCMs, SEFs, and DCOs, some of which will be designated as systemically important DCOs. The Commission previously has determined that DCMs, SEFs, and DCOs are not "small entities" for purposes of the RFA.[122] In determining that these registered entities are not "small entities," the Commission reasoned that it designates a contract market, or registers a DCO or SEF, only if the entity meets a number of specific criteria, including the expenditure of sufficient resources to establish and maintain an adequate self-regulatory program.[123] Because DCMs, SEFs, and DCOs are required to demonstrate compliance with Core Principles, including principles concerning the maintenance or expenditure of financial resources, the Commission determined that such registered entities are not "small entities" for the purposes of the RFA. Thus, with respect to DCMs, SEFs, and DCOs, the Commission believes that the final rules will not have a significant economic impact on a substantial number of small entities.

Accordingly, pursuant to Section 605(b) of the RFA, 5 U.S.C. 605(b), the Chairman, on behalf of the Commission, certifies that these rules and rule amendments will not have a significant economic impact on a substantial number of small entities.

B. Paperwork Reduction Act

1. Customer Clearing Documentation

Participant Recordkeeping and Reporting, Duties, and Conflicts of Interest Policies and Procedures; Futures Commission Merchant and Introducing Broker Conflicts of Interest Policies and Procedures; Swap Dealer, Major Swap Participant, and Futures Commission Merchant Chief Compliance Officer," available at http://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/DF_4_BusConductStandardsInternal/ssLINK/federalregister022312b.

[122] 76 FR 44776, 44789 (July 27, 2011) ("Provisions Common to Registered Entities"); see 66 FR 45604, 45609 (Aug. 29, 2001); 47 FR 18618, 18619 (Apr. 30, 1982).

[123] See, e.g., Core Principle 2 applicable to SEFs under Section 733 of the Dodd-Frank Act.

Pursuant to the Paperwork Reduction Act ("PRA"),[124] the Commission may not conduct or sponsor, and a registrant is not required to respond to, a collection of information unless it displays a currently valid Office of Management and Budget ("OMB") control number. The final rules set forth in this Adopting Release relating to Customer Clearing Documentation will result in new collection of information requirements within the meaning of the PRA.

Accordingly, the Commission requested control numbers for the required collection of information. The Commission has submitted this notice of final rulemaking along with supporting documentation for OMB's review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The title for this collection of information is "Customer Clearing Documentation and Timing of Acceptance for Clearing." The OMB has assigned this collection control number 3038-0092.

The collection of information under these regulations is necessary to implement certain provisions of the CEA, as amended by the Dodd-Frank Act. Specifically, it is essential to reducing risk and fostering open access to clearing and execution of customer transactions on a DCM or SEF on terms that have a reasonable relationship to the best terms available by prohibiting restrictions in customer clearing documentation of SDs, MSPs, FCMs, or DCOs that could delay or block access to clearing, increase costs, and reduce market efficiency by limiting the number of counterparties available for trading. These regulations are also crucial both for effective risk management and for the efficient operation of trading venues among SDs, MSPs, FCMs, and DCOs.

Many responses to this collection of information will be mandatory. The Commission protects proprietary information according to the Freedom of Information

[124] 44 U.S.C. 3501 et seq.

Act and 17 CFR Part 145, "Commission Records and Information." In addition, section 8(a)(1) of the CEA strictly prohibits the Commission, unless specifically authorized by the CEA, from making public "data and information that would separately disclose the business transactions or market positions of any person and trade secrets or names of customers." The Commission is also required to protect certain information contained in a government system of records according to the Privacy Act of 1974, 5 U.S.C. 552a.

a. Information Provided by Reporting Entities/Persons

SDs, MSPs, FCMs, and DCOs will be required to develop and maintain written customer clearing documentation in compliance with §§ 1.72, 23.608, and 39.12. Section 39.12(b)(7)(i)(B) requires DCOs to coordinate with clearing members to establish systems for prompt processing of trades. Sections 1.74(a) and 23.610(a) require reciprocal coordination with DCOs by FCMs, SDs, and MSPs that are clearing members.

The annual burden associated with these regulations is estimated to be 16 hours, at an annual cost of $1,600 for each FCM, SD, and MSP. Burden means the total time, effort, or financial resources expended by persons to generate, maintain, retain, disclose, or provide information to or for a federal agency. The Commission has characterized the annual costs as initial costs because the Commission anticipates that the cost burdens will be reduced dramatically over time as the documentation and procedures required by these regulations become increasingly standardized within the industry.

Sections 1.72 and 23.608 require each FCM, SD, and MSP to ensure compliance with these regulations. Maintenance of contracts is prudent business practice and the Commission anticipates that SDs and MSPs already maintain some form of this documentation. Additionally, the Commission believes that much of the existing

customer clearing documentation already complies with these rules, and therefore that compliance will require a minimal burden.

In addition to the above, the Commission anticipates that FCMs, SDs, and MSPs will spend an average of another 16 hours per year drafting and, as needed, updating customer clearing documentation to ensure compliance required by §§ 1.72 and 23.608.

For each DCO, the annual burden associated with these regulations is estimated to be 40 hours, at an annual cost of $4,000. Burden means the total time, effort, or financial resources expended by persons to generate, maintain, retain, disclose, or provide information to or for a federal agency. The Commission has characterized the annual costs as initial costs because the Commission anticipates that the cost burdens will be reduced dramatically over time as the documentation and procedures required by the regulations are implemented. Any additional expenditure related to § 39.12 likely would be limited to the time required to review -- and, as needed, amend -- existing documentation and procedures.

Section 39.12(b)(7) requires each DCO to coordinate with clearing members to establish systems for prompt processing of trades. The Commission believes that this is currently a practice of DCOs. Accordingly, any additional expenditure related to § 39.12(b)(7) likely would be limited to the time initially required to review -- and, as needed, amend -- existing trade processing procedures to ensure that they conform to all of the required elements and to coordinate with FCMs, SDs, and MSPs to establish reciprocal procedures.

The Commission anticipates that DCOs will spend an average of 20 hours per year drafting -- and, as needed, updating -- the written policies and procedures to ensure

compliance required by § 39.12, and 20 hours per year coordinating with FCMs, SDs, and MSPs on reciprocal procedures.

The hour burden calculations below are based upon a number of variables such as the number of FCMs, SDs, MSPs, and DCOs in the marketplace and the average hourly wage of the employees of these registrants that would be responsible for satisfying the obligations established by the proposed regulation.

There are currently 134 FCMs and 14 DCOs based on industry data. SDs and MSPs are new categories of registrants. Accordingly, it is not currently known how many SDs and MSPs will become subject to these rules, and this will not be known to the Commission until the registration requirements for these entities become effective. The Commission believes there will be approximately 125 SDs and MSPs who will be required to comply with the recordkeeping requirements of the proposed rules. The Commission estimated the number of affected entities based on industry data.

According to recent Bureau of Labor Statistics, the mean hourly wage of an employee under occupation code 11-3031, "Financial Managers," (which includes operations managers) that is employed by the "Securities and Commodity Contracts Intermediation and Brokerage" industry is $74.41.[125] Because SDs, MSPs, FCMs, and DCOs include large financial institutions whose operations management employees' salaries may exceed the mean wage, the Commission has estimated the cost burden of these proposed regulations based upon an average salary of $100 per hour.

Accordingly, the estimated hour burden was calculated as follows:

Developing Written Procedures for Compliance, and Maintaining Records Documenting Compliance for SDs and MSPs. This hourly burden arises from the

[125] http://www.bls.gov/oes/current/oes113031.htm.

requirement that SDs and MSPs make and maintain records documenting compliance related to client clearing documentation.

Number of registrants: 125

Frequency of collection: as needed

Estimated number of annual responses per registrant: 1

Estimated aggregate number of annual responses: 125

Estimated annual hour burden per registrant: 16 hours

Estimated aggregate annual hour burden: 2,000 burden hours [125 registrants x 16 hours per registrant]

Developing Written Procedures for Compliance, and Maintaining Records Documenting Compliance for FCMs. This hourly burden arises from the requirement that FCMs make and maintain records documenting compliance related to client clearing documentation.

Number of registrants: 134

Frequency of collection: as needed

Estimated number of annual responses per registrant: 1

Estimated aggregate number of annual responses: 134

Estimated annual hour burden per registrant: 16 hours

Estimated aggregate annual hour burden: 2,144 burden hours [134 registrants x 16 hours per registrant]

Drafting and Updating Trade Processing Procedures for DCOs. This hour burden arises from the time necessary to develop and periodically update the trade processing procedures required by the regulations.

Number of registrants: 14

Frequency of collection: Initial drafting, updating as needed

Estimated number of annual responses per registrant: 1

Estimated aggregate number of annual responses: 14

Estimated annual hour burden per registrant: 40 hours

Estimated aggregate annual hour burden: 560 burden hours [14 registrants x 40 hours per registrant]

Based upon the above, the aggregate hour burden cost for all registrants is 4,704 burden hours and $470,400 [4,704 x $100 per hour].

2. Time Frames for Acceptance into Clearing

The Commission believes that the final rules set forth in this Adopting Release relating to the Time Frames for Acceptance into Clearing will not impose any new information collection requirements that require approval of OMB under the PRA.

3. Clearing Member Risk Management

The final rules contained in this Adopting Release relating to Clearing Member Risk Management will result in new collection of information requirements within the meaning of the PRA. Accordingly, the Commission requested control numbers for the required collection of information. The Commission has submitted this notice of final rulemaking along with supporting documentation for OMB's review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The title for this collection of information is "Clearing Member Risk Management." An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a

currently valid control number. The OMB has assigned this collection control number 3038-0094.

The collection of information under these regulations is necessary to implement certain provisions of the CEA, as amended by the Dodd-Frank Act. Specifically, it is essential both for effective risk management and for the efficient operation of trading venues on which SDs, MSPs, and FCMs participate. The position risk management requirement established by the rules diminishes the chance for a default, thus ensuring the financial integrity of markets as well as customer protection.

Responses to this collection of information will be mandatory. The Commission protects proprietary information according to the Freedom of Information Act and 17 CFR Part 145, "Commission Records and Information." In addition, section 8(a)(1) of the CEA strictly prohibits the Commission, unless specifically authorized by the CEA, from making public "data and information that would separately disclose the business transactions or market positions of any person and trade secrets or names of customers." The Commission is also required to protect certain information contained in a government system of records according to the Privacy Act of 1974, 5 U.S.C. 552a.

a. Information Provided by Reporting Entities/Persons

SDs, MSPs, and FCMs will be required to develop and monitor procedures for position risk management in accordance with §§ 1.73 and 23.609.

The annual burden associated with these regulations is estimated to be 524 hours, at an annual cost of $52,400 for each FCM, SD, and MSP. Burden means the total time, effort, or financial resources expended by persons to generate, maintain, retain, disclose, or provide information to or for a federal agency. The Commission has characterized the

annual costs as initial costs because the Commission anticipates that the cost burdens will be reduced dramatically over time as the documentation and procedures required by the regulations become increasingly standardized within the industry.

This hourly burden primarily results from the position risk management obligations that will be imposed by §§ 1.73 and 23.609. Sections 1.73 and 23.609 will require each FCM, SD, and MSP to establish and enforce procedures to establish risk-based limits, conduct stress testing, evaluate the ability to meet initial and variation margin, test lines of credit, and evaluate the ability to liquidate, in an orderly manner, the positions in the proprietary and customer accounts and estimate the cost of the liquidation. The Commission believes that each of these items is currently an element of existing risk management programs at a DCO or an FCM. Accordingly, any additional expenditure related to §§ 1.73 and 23.609 likely will be limited to the time initially required to review and, as needed, amend, existing risk management procedures to ensure that they encompass all of the required elements and to develop a system for performing these functions as often as required.

In addition, §§ 1.73 and 23.609 will require each FCM, SD, and MSP to establish written procedures to comply, and maintain records documenting compliance. Maintenance of compliance procedures and records of compliance is prudent business practice and the Commission anticipates that FCMs, SDs, and MSPs already maintain some form of this documentation.

With respect to the required position risk management, the Commission estimates that FCMs, SDs, and MSPs will spend an average of 2 hours per trading day, or 504 hours per year, performing the required tests. The Commission notes that the specific information

required for these tests is of the type that would be performed in a prudent market participant's ordinary course of business.

In addition to the above, the Commission anticipates that FCMs, SDs, and MSPs will spend an average of 16 hours per year drafting and, as needed, updating the written policies and procedures to ensure compliance required by §§ 1.73 and 23.609, and 4 hours per year maintaining records of the compliance.

The hour burden calculations below are based upon a number of variables such as the number of FCMs, SDs, and MSPs in the marketplace and the average hourly wage of the employees of these registrants that will be responsible for satisfying the obligations established by the regulations.

There are currently 134 FCMs based on industry data. SDs and MSPs are new categories of registrants. Accordingly, it is not currently known how many SDs and MSPs will become subject to these rules, and this will not be known to the Commission until the registration requirements for these entities become effective. The Commission believes there will be approximately 125 SDs and MSPs who will be required to comply with the recordkeeping requirements of the proposed rules. The Commission estimated the number of affected entities based on industry data.

According to recent Bureau of Labor Statistics, the mean hourly wage of an employee under occupation code 11-3031, "Financial Managers," (which includes operations managers) that is employed by the "Securities and Commodity Contracts Intermediation and Brokerage" industry is $74.41.[126] Because SDs, MSPs, and FCMs include large financial institutions whose operations management employees' salaries may exceed the

[126] http://www.bls.gov/oes/current/oes113031.htm.

mean wage, the Commission has estimated the cost burden of these regulations based upon an average salary of $100 per hour.

Accordingly, the estimated hour burden was calculated as follows:

Developing and Conducting Position Risk Management Procedures for SDs and MSPs. This hourly burden arises from the requirement that SDs and MSPs establish and perform testing of clearing member risk management procedures.

Number of registrants: 125

Frequency of collection: daily

Estimated number of responses per registrant: 252 [252 trading days]

Estimated aggregate number of responses: 31,500 [125 registrants x 252 trading days]

Estimated annual burden per registrant: 504 hours [252 trading days x 2 hours per record]

Estimated aggregate annual hour burden: 63,000 hours [125 registrants x 252 trading days x 2 hours per record]

Developing Written Procedures for Compliance, and Maintaining Records Documenting Compliance for SDs and MSPs. This hourly burden arises from the requirement that SDs and MSPs make and maintain records documenting compliance related to clearing member risk management.

Number of registrants: 125

Frequency of collection: as needed

Estimated number of annual responses per registrant: 1

Estimated aggregate number of annual responses: 125

Estimated annual hour burden per registrant: 20 hours

Estimated aggregate annual hour burden: 2,500 burden hours [125 registrants x 20 hours per registrant]

Developing and Conducting Position Risk Management Procedures for FCMs. This hourly burden arises from the requirement that FCMs establish and perform testing of clearing member risk management procedures.

Number of registrants: 134

Frequency of collection: daily

Estimated number of responses per registrant: 252 [252 trading days]

Estimated aggregate number of responses: 33,768 [134 registrants x 252 trading days]

Estimated annual burden per registrant: 504 hours [252 trading days x 2 hours per record]

Estimated aggregate annual hour burden: 67,536 hours [134 registrants x 252 trading days x 2 hours per record]

Developing Written Procedures for Compliance, and Maintaining Records Documenting Compliance for FCMs. This hourly burden arises from the requirement that FCMs make and maintain records documenting compliance related to clearing member risk management.

Number of registrants: 134

Frequency of collection: as needed

Estimated number of annual responses per registrant: 1

Estimated aggregate number of annual responses: 134

Estimated annual hour burden per registrant: 20 hours

Estimated aggregate annual hour burden: 2,680 burden hours [134 registrants x 20 hours per registrant]

Based upon the above, the aggregate hour burden cost for all registrants is 135,716 burden hours and $13,571,600 [227,416 x $100 per hour].

In addition to the per hour burden discussed above, the Commission anticipates that SDs, MSPs, and FCMs may incur certain start-up costs in connection with the recordkeeping obligations. Such costs may include the expenditures related to re-programming or updating existing recordkeeping technology and systems to enable the SD, MSP, or FCM to collect, capture, process, maintain, and re-produce any newly required records. The Commission believes that SDs, MSPs, and FCMs generally could adapt their current infrastructure to accommodate the new or amended technology and thus no significant infrastructure expenditures would be needed. The Commission estimates the programming burden hours associated with technology improvements to be 60 hours.

According to recent Bureau of Labor Statistics, the mean hourly wages of computer programmers under occupation code 15-1021 and computer software engineers under program codes 15-1031 and 1032 are between $34.10 and $44.94.[127] Because SDs, MSPs, and FCMs generally will be large entities that may engage employees with wages above the mean, the Commission has conservatively chosen to use a mean hourly programming wage of $60 per hour. Accordingly, the start-up burden associated with the required technological improvements is $3,600 [$60 x 60 hours] per affected registrant or $932,400 [$3,600 x 259 registrants] in the aggregate.

[127] http://www.bls.gov/oes/current/oes113031.htm.

List of Subjects

17 CFR Part 1

Conflicts of interest, Futures commission merchants, Major swap participants, Swap dealers.

17 CFR Part 23

Conflicts of interests, Futures commission merchants, Major swap participants, Swap dealers.

17 CFR Part 37

Swaps, Swap execution facilities.

17 CFR Part 38

Block transaction, Commodity futures, Designated contract markets, Transactions off the centralized market.

17 CFR Part 39

Derivatives clearing organizations, Risk management, Swaps.

In light of the foregoing, the Commission hereby amends part 1; part 23, as proposed at 75 FR 71390, November 23, 2010, amended at 75 FR 81530, December 28, 2010, further amended at 76 FR 45730, August 1, 2011, 76 FR 45724, August 1, 2011, and 76 FR 47529, August 5, 2011; part 37, as proposed to be revised at 76 FR 1237, January 7, 2011, and further amended at 76 FR 13101, March 10, 2011; part 38, as proposed to be amended at 75 FR 80606, December 22, 2010, and further amended at 76 FR 13101, March 10, 2011; and part 39, as amended at 76 FR 3717, January 20, 2011, amended at 76 FR 13101, March 10, 2011, and further amended at 76 FR 45730, August 1, 2011, and 76 FR 47529, August 5, 2011 of Title 17 of the Code of Federal Regulations as follows:

PART 1—GENERAL REGULATIONS UNDER THE COMMODITY EXCHANGE ACT

1. Revise the authority citation for part 1 to read as follows:

Authority: 7 U.S.C. 1a, 2, 2a, 5, 6, 6a, 6b, 6c, 6d, 6e, 6f, 6g, 6h, 6i, 6k, 6l, 6m, 6n, 6o, 6p, 6r, 6s, 7, 7a–1, 7a–2, 7b, 7b–3, 8, 9, 10a, 12, 12a, 12c, 13a, 13a–1, 16, 16a, 19, 21, 23, and 24, as amended by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, 124 Stat. 1376 (2010).

2. Amend § 1.35 to part 1 to read as follows:

§ 1.35 Records of commodity interest and cash commodity transactions

(a-1)(5) * * *

(iv) Allocation. Orders eligible for post-execution allocation must be allocated by an eligible account manager in accordance with the following:

(A) Allocations must be made as soon as practicable after the entire transaction is executed, but in any event no later than the following times: For cleared trades, account managers must provide allocation information to futures commission merchants no later than a time sufficiently before the end of the day the order is executed to ensure that clearing records identify the ultimate customer for each trade. For uncleared trades, account managers must provide allocation information to the counterparty no later than the end of the calendar day that the swap was executed.

(B) Allocations must be fair and equitable. No account or group of accounts may receive consistently favorable or unfavorable treatment.

(C) The allocation methodology must be sufficiently objective and specific to permit independent verification of the fairness of the allocations using that methodology by appropriate regulatory and self-regulatory authorities and by outside auditors.

3. Add § 1.72 to part 1 to read as follows:

§ 1.72 Restrictions on customer clearing arrangements

No futures commission merchant providing clearing services to customers shall enter into an arrangement that:

(a) Discloses to the futures commission merchant or any swap dealer or major swap participant the identity of a customer's original executing counterparty;

(b) Limits the number of counterparties with whom a customer may enter into a trade;

(c) Restricts the size of the position a customer may take with any individual counterparty, apart from an overall limit for all positions held by the customer at the futures commission merchant;

(d) Impairs a customer's access to execution of a trade on terms that have a reasonable relationship to the best terms available; or

(e) Prevents compliance with the time frames set forth in § 1.74(b), § 23.610(b), or § 39.12(b)(7) of this chapter.

4. Add § 1.73 to part 1 to read as follows:

§ 1.73 Clearing futures commission merchant risk management

(a) Each futures commission merchant that is a clearing member of a derivatives clearing organization shall:

(1) Establish risk-based limits in the proprietary account and in each customer account based on position size, order size, margin requirements, or similar factors;

(2) Screen orders for compliance with the risk-based limits in accordance with the following:

(i) When a clearing futures commission merchant provides electronic market access or accepts orders for automated execution, it shall use automated means to screen orders for compliance with the limits;

(ii) When a clearing futures commission merchant accepts orders for non-automated execution, it shall establish and maintain systems of risk controls reasonably designed to ensure compliance with the limits;

(iii) When a clearing futures commission merchant accepts transactions that were executed bilaterally and then submitted for clearing, it shall establish and maintain systems of risk management controls reasonably designed to ensure compliance with the limits;

(iv) When a firm executes an order on behalf of a customer but gives it up to another firm for clearing,

(A) the clearing futures commission merchant shall establish risk-based limits for the customer, and enter into an agreement in advance with the executing firm that requires the executing firm to screen orders for compliance with those limits in accordance with paragraph (a)(2)(i) or paragraph (a)(2)(ii) as applicable; and

(B) the clearing futures commission merchant shall establish and maintain systems of risk management controls reasonably designed to ensure compliance with the limits.

(v) When an account manager bunches orders on behalf of multiple customers for execution as a block and post-trade allocation to individual accounts for clearing:

(A) the futures commission merchant that initially clears the block shall establish risk-based limits for the block account and screen the order in accordance with paragraph (a)(2)(i) or paragraph (a)(2)(ii) as applicable;

(B) the futures commission merchants that clear the allocated trades on behalf of customers shall establish risk-based limits for each customer and enter into an agreement in advance with the account manager that requires the account manager to screen orders for compliance with those limits; and

(C) the futures commission merchants that clear the allocated trades on behalf of customers shall establish and maintain systems of risk management controls reasonably designed to ensure compliance with the limits.

(3) Monitor for adherence to the risk-based limits intra-day and overnight;

(4) Conduct stress tests under extreme but plausible conditions of all positions in the proprietary account and in each customer account that could pose material risk to the futures commission merchant at least once per week;

(5) Evaluate its ability to meet initial margin requirements at least once per week;

(6) Evaluate its ability to meet variation margin requirements in cash at least once per week;

(7) Evaluate its ability to liquidate, in an orderly manner, the positions in the proprietary and customer accounts and estimate the cost of the liquidation at least once per quarter; and

(8) Test all lines of credit at least once per year.

(b) Each futures commission merchant that is a clearing member of a derivatives clearing organization shall:

(1) Establish written procedures to comply with this regulation; and

(2) Keep full, complete, and systematic records documenting its compliance with this regulation.

(3) All records required to be maintained pursuant to these regulations shall be maintained in accordance with Commission Regulation § 1.31 and shall be made available promptly upon request to representatives of the Commission and to representatives of applicable prudential regulators.

5. Add § 1.74 to part 1 to read as follows:

§ 1.74 Futures commission merchant acceptance for clearing

(a) Each futures commission merchant that is a clearing member of a derivatives clearing organization shall coordinate with each derivatives clearing organization on which it clears to establish systems that enable the futures commission merchant, or the derivatives clearing organization acting on its behalf, to accept or reject each trade submitted to the derivatives clearing organization for clearing by or for the futures commission merchant or a customer of the futures commission merchant as quickly as would be technologically practicable if fully automated systems were used; and

(b) Each futures commission merchant that is a clearing member of a derivatives clearing organization shall accept or reject each trade submitted by or for it or its customers as quickly as would be technologically practicable if fully automated systems were used; a clearing futures commission merchant may meet this requirement by:

(1) Establishing systems to pre-screen orders for compliance with criteria specified by the clearing futures commission merchant;

(2) Establishing systems that authorize a derivatives clearing organization to accept or reject on its behalf trades that meet, or fail to meet, criteria specified by the clearing futures commission merchant; or

(3) Establishing systems that enable the clearing futures commission merchant to communicate to the derivatives clearing organization acceptance or rejection of each trade as quickly as would be technologically practicable if fully automated systems were used.

6. Add § 1.75 to part 1, to read as follows:

§ 1.75 Delegation of authority to the Director of the Division of Clearing and Risk to establish an alternative compliance schedule to comply with futures commission merchant acceptance for clearing.

(a) The Commission hereby delegates to the Director of the Division of Clearing and Risk or such other employee or employees as the Director may designate from time to time, the authority to establish an alternative compliance schedule for requirements of § 1.74 for swaps that are found to be technologically or economically impracticable for an affected futures commission merchant that seeks, in good faith, to comply with the requirements of § 1.74 within a reasonable time period beyond the date on which compliance by such futures commission merchant is otherwise required.

(b) A request for an alternative compliance schedule under this section shall be acted upon by the Director of the Division of Clearing and Risk within 30 days from the time such a request is received, or it shall be deemed approved.

(c) An exception granted under this section shall not cause a registrant to be out of compliance or deemed in violation of any registration requirements.

(d) Notwithstanding any other provision of this section, in any case in which a Commission employee delegated authority under this section believes it appropriate, he or she may submit to the Commission for its consideration the question of whether an alternative compliance schedule should be established. Nothing in this section shall be deemed to prohibit the Commission, at its election, from exercising the authority delegated in this section.

PART 23 – SWAP DEALERS AND MAJOR SWAP PARTICIPANTS

7. Revise the authority citation for part 23 to read as follows:

Authority: 7 U.S.C. 1a, 2, 6, 6a, 6b, 6b–1, 6c, 6p, 6r, 6s, 6t, 9, 9a, 12, 12a, 13b, 13c, 16a, 18, 19, 21.

8. Add § 23.506 to part 23, subpart I, to read as follows:

§ 23.506 Swap processing and clearing.

(a) Swap processing.

(1) Each swap dealer and major swap participant shall ensure that it has the capacity to route swap transactions not executed on a swap execution facility or designated contract market to a derivatives clearing organization in a manner acceptable to the derivatives clearing organization for the purposes of clearing; and

(2) Each swap dealer and major swap participant shall coordinate with each derivatives clearing organization to which the swap dealer, major swap participant, or its clearing member submits transactions for clearing, to facilitate prompt and efficient swap transaction processing in accordance with the requirements of § 39.12(b)(7) of this chapter.

(b) Swap clearing. With respect to each swap that is not executed on a swap execution facility or a designated contract market, each swap dealer and major swap participant shall:

(1) If such swap is subject to a mandatory clearing requirement pursuant to section 2(h)(1) of the Act and an exception pursuant to 2(h)(7) is not applicable, submit such swap for clearing to a derivatives clearing organization as soon as technologically practicable after execution of the swap, but no later than the close of business on the day of execution; or

(2) If such swap is not subject to a mandatory clearing requirement pursuant to section 2(h)(1) of the Act but is accepted for clearing by any derivatives clearing organization and the swap dealer or major swap participant and its counterparty agree that such swap will be submitted for clearing, submit such swap for clearing not later than the next business day after execution of the swap, or the agreement to clear, if later than execution.

9. Add § 23.608 to part 23, subpart J, to read as follows:

§ 23.608 Restrictions on counterparty clearing relationships.

No swap dealer or major swap participant entering into a swap to be submitted for clearing with a counterparty that is a customer of a futures commission merchant shall enter into an arrangement that:

(a) Discloses to the futures commission merchant or any swap dealer or major swap participant the identity of a customer's original executing counterparty;

(b) Limits the number of counterparties with whom a customer may enter into a trade;

(c) Restricts the size of the position a customer may take with any individual counterparty, apart from an overall limit for all positions held by the customer with the swap dealer or major swap participant;

(d) Impairs a customer's access to execution of a trade on terms that have a reasonable relationship to the best terms available; or

(e) Prevents compliance with the time frames set forth in § 1.74(b), § 23.610(b), or § 39.12(b)(7) of this chapter.

10. Add § 23.609 to part 23, subpart J, to read as follows:

§ 23.609 Clearing member risk management

(a) With respect to clearing activities in futures, security futures products, swaps, agreements, contracts, or transactions described in section 2(c)(2)(C)(i) or section 2(c)(2)(D)(i) of the Act, commodity options authorized under section 4c of the Act, or leveraged transactions authorized under section 19 of the Act, each swap dealer or major swap participant that is a clearing member of a derivatives clearing organization shall:

(1) Establish risk-based limits based on position size, order size, margin requirements, or similar factors;

(2) Screen orders for compliance with the risk-based limits in accordance with the following:

(i) For transactions subject to automated execution, the clearing member shall use automated means to screen orders for compliance with the risk-based limits; and

(ii) For transactions subject to non-automated execution, the clearing member shall establish and maintain systems of risk controls reasonably designed to ensure compliance with the limits.

(3) Monitor for adherence to the risk-based limits intra-day and overnight;

(4) Conduct stress tests under extreme but plausible conditions of all positions at least once per week;

(5) Evaluate its ability to meet initial margin requirements at least once per week;

(6) Evaluate its ability to meet variation margin requirements in cash at least once per week;

(7) Evaluate its ability to liquidate the positions it clears in an orderly manner, and estimate the cost of the liquidation ; and

(8) Test all lines of credit at least once per year.

(b) Each swap dealer or major swap participant that is a clearing member of a derivatives clearing organization shall:

(1) Establish written procedures to comply with this regulation; and

(2) Keep full, complete, and systematic records documenting its compliance with this regulation.

(3) All records required to be maintained pursuant to these regulations shall be maintained in accordance with Commission Regulation § 1.31 and shall be made available promptly upon request to representatives of the Commission and to representatives of applicable prudential regulators.

11. Add § 23.610 to part 23, subpart J, to read as follows:

§ 23.610 Clearing member acceptance for clearing

(a) Each swap dealer or major swap participant that is a clearing member of a derivatives clearing organization shall coordinate with each derivatives clearing organization on which it clears to establish systems that enable the clearing member, or

the derivatives clearing organization acting on its behalf, to accept or reject each trade submitted to the derivatives clearing organization for clearing by or for the clearing member as quickly as would be technologically practicable if fully automated systems were used; and

(b) Each swap dealer or major swap participant that is a clearing member of a derivatives clearing organization shall accept or reject each trade submitted by or for it as quickly as would be technologically practicable if fully automated systems were used; a clearing member may meet this requirement by:

(1) Establishing systems to pre-screen orders for compliance with criteria specified by the clearing member;

(2) Establishing systems that authorize a derivatives clearing organization to accept or reject on its behalf trades that meet, or fail to meet, criteria specified by the clearing member; or

(3) Establishing systems that enable the clearing member to communicate to the derivatives clearing organization acceptance or rejection of each trade as quickly as would be technologically practicable if fully automated systems were used.

12. Add § 23.611 to part 23, subpart J, to read as follows:

§ 23.611 Delegation of authority to the Director of the Division of Clearing and Risk to establish an alternative compliance schedule to comply with clearing member acceptance for clearing.

(a) The Commission hereby delegates to the Director of the Division of Clearing and Risk or such other employee or employees as the Director may designate from time to time, the authority to establish an alternative compliance schedule for requirements of

§ 23.610 for swaps that are found to be technologically or economically impracticable for an affected swap dealer or major swap participant that seeks, in good faith, to comply with the requirements of § 23.610 within a reasonable time period beyond the date on which compliance by such swap dealer or major swap participant is otherwise required.

(b) A request for an alternative compliance schedule under this section shall be acted upon by the Director of the Division of Clearing and Risk within 30 days from the time such a request is received, or it shall be deemed approved.

(c) An exception granted under this section shall not cause a registrant to be out of compliance or deemed in violation of any registration requirements.

(d) Notwithstanding any other provision of this section, in any case in which a Commission employee delegated authority under this section believes it appropriate, he or she may submit to the Commission for its consideration the question of whether an alternative compliance schedule should be established. Nothing in this section shall be deemed to prohibit the Commission, at its election, from exercising the authority delegated in this section.

PART 37—SWAP EXECUTION FACILITIES

13. Revise the authority citation for part 37 to read as follows:

Authority: 7 U.S.C. 1a, 2, 5, 6, 6c, 7, 7a–2, 7b–3 and 12a, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, 124 Stat. 1376.

Subpart H—Financial Integrity of Transactions

14. Amend § 37.702 by revising paragraph (b) to read as follows:

§ 37.702 General financial integrity

* * * * *

(b) For transactions cleared by a derivatives clearing organization:

(1) By ensuring that the swap execution facility has the capacity to route transactions to the derivatives clearing organization in a manner acceptable to the derivatives clearing organization for purposes of clearing; and

(2) By coordinating with each derivatives clearing organization to which it submits transactions for clearing, in the development of rules and procedures to facilitate prompt and efficient transaction processing in accordance with the requirements of § 39.12(b)(7) of this chapter.

* * * * *

PART 38—DESIGNATED CONTRACT MARKETS

15. Revise the authority citation for part 38 to read as follows:

Authority: 7 U.S.C. 1a, 2, 6, 6a, 6c, 6d, 6e, 6f, 6g, 6i, 6j, 6k, 6l, 6m, 6n, 7, 7a–2, 7b, 7b–1, 7b–3, 8, 9, 15, and 21, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, 124 Stat. 1376.

Subpart L—Financial Integrity of Transactions

16. Amend § 38.601 to read as follows:

§ 38.601 Mandatory clearing

(a) Transactions executed on or through the designated contract market, other than transactions in security futures products, must be cleared through a registered derivatives clearing organization, in accordance with the provisions of part 39 of this chapter.

(b) A designated contract market must coordinate with each derivatives clearing organization to which it submits transactions for clearing, in the development of rules and procedures to facilitate prompt and efficient transaction processing in accordance with the requirements of § 39.12(b)(7) of this chapter.

PART 39 – DERIVATIVES CLEARING ORGANIZATIONS

17. Revise the authority citation for part 39 to read as follows:

Authority: 7 U.S.C. 2, and 7a–1 as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, 124 Stat. 1376.

Subpart B – Compliance with Core Principles

18. In § 39.12, add paragraph (a)(1)(vi) to read as follows:

§ 39.12 Participant and product eligibility.

(a) * * *

(1) * * *

(vi) No derivatives clearing organization shall require as a condition of accepting a swap for clearing that a futures commission merchant enter into an arrangement with a customer that:

(A) Discloses to the futures commission merchant or any swap dealer or major swap participant the identity of a customer's original executing counterparty;

(B) Limits the number of counterparties with whom a customer may enter into trades;

(C) Restricts the size of the position a customer may take with any individual counterparty, apart from an overall limit for all positions held by the customer at the futures commission merchant;

(D) Impairs a customer's access to execution of a trade on terms that have a reasonable relationship to the best terms available; or

(E) Prevents compliance with the time frames set forth in § 1.74(b), § 23.610(b), or § 39.12(b)(7) of this chapter.

* * * * *

19. Amend § 39.12 by revising paragraph (b)(7) to read as follows:

§ 39.12 Participant and product eligibility

(a) * * *

(b) * * *

(7) Time frame for clearing.

(i) Coordination with markets and clearing members.

(A) Each derivatives clearing organization shall coordinate with each designated contract market and swap execution facility that lists for trading a product that is cleared by the derivatives clearing organization in developing rules and procedures to facilitate prompt, efficient, and accurate processing of all transactions submitted to the derivatives clearing organization for clearing.

(B) Each derivatives clearing organization shall coordinate with each clearing member that is a futures commission merchant, swap dealer, or major swap participant to establish systems that enable the clearing member, or the derivatives clearing organization acting on its behalf, to accept or reject each trade submitted to the derivatives clearing

organization for clearing by or for the clearing member or a customer of the clearing member as quickly as would be technologically practicable if fully automated systems were used.

(ii) Transactions executed competitively on or subject to the rules of a designated contract market or swap execution facility. A derivatives clearing organization shall have rules that provide that the derivatives clearing organization will accept or reject for clearing as quickly after execution as would be technologically practicable if fully automated systems were used, all contracts that are listed for clearing by the derivatives clearing organization and are executed competitively on or subject to the rules of a designated contract market or a swap execution facility. The derivatives clearing organization shall accept all trades:

(A) For which the executing parties have clearing arrangements in place with clearing members of the derivatives clearing organization;

(B) For which the executing parties identify the derivatives clearing organization as the intended clearinghouse; and

(C) That satisfy the criteria of the derivatives clearing organization, including but not limited to applicable risk filters; provided that such criteria are non-discriminatory across trading venues and are applied as quickly as would be technologically practicable if fully automated systems were used.

(iii) Swaps not executed on or subject to the rules of a designated contract market or a swap execution facility or executed non-competitively on or subject to the rules of a designated contract market or a swap execution facility. A derivatives clearing organization shall have rules that provide that the derivatives clearing organization will

accept or reject for clearing as quickly after submission to the derivatives clearing organization as would be technologically practicable if fully automated systems were used, all swaps that are listed for clearing by the derivatives clearing organization and are not executed on or subject to the rules of a designated contract market or a swap execution facility or executed non-competitively on or subject to the rules of a designated contract market or a swap execution facility. The derivatives clearing organization shall accept all trades:

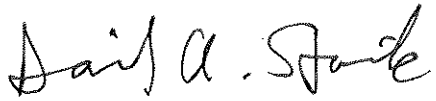
(A) That are submitted by the parties to the derivatives clearing organization, in accordance with § 23.506 of this chapter;

(B) For which the executing parties have clearing arrangements in place with clearing members of the derivatives clearing organization;

(C) For which the executing parties identify the derivatives clearing organization as the intended clearinghouse; and

(D) That satisfy the criteria of the derivatives clearing organization, including but not limited to applicable risk filters; provided that such criteria are non-discriminatory across trading venues and are applied as quickly as would be technologically practicable if fully automated systems were used.

Issued in Washington, DC, on March 20, 2012, by the Commission.



David A. Stawick,

Secretary of the Commission.

Appendices to Customer Clearing Documentation, Timing of Acceptance for Clearing, and

Clearing Member Risk Management—Commission Voting Summary and Statements of Commissioners

NOTE: The following appendices will not appear in the Code of Federal Regulations

Appendix 1—Commission Voting Summary

On this matter, Chairman Gensler and Commissioners Sommers, Chilton, and Wetjen voted in the affirmative; Commissioner O'Malia voted in the negative.

Appendix 2—Statement of Chairman Gensler

I support today's final rulemaking on clearing which will promote market participants' access to central clearing, increase market transparency, foster competition, support market efficiency, and bolster risk management. These rules include provisions on client clearing documentation, so-called 'straight-through' processing, bunched orders, and clearing member risk management.

These final rules have all benefited from broad public comment.

One of the primary goals of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) is to lower risks to the public by increasing the use of central clearing and to promote the financial integrity of the markets and the clearing system. These rules are an important step in furtherance of these goals.

First, the final rule does so by establishing requirements for the documentation between a Futures Commission Merchant (FCM) and its customers and between a Swap Dealer and its counterparties. This rule will foster bilateral clearing arrangements between customers and their FCM. The rule will promote competition in the provision of clearing services and swap liquidity to the broad public by limiting one FCM or Swap Dealer from restricting a customer or counterparty access to other market participants.

Second, the final rule does so by setting standards for the timely processing of trades through so-called 'straight-through' processing or sending transactions promptly to the clearinghouse upon execution. This lowers risk to the markets by minimizing the time between submission and acceptance or rejection of trades for clearing. These regulations would require and establish uniform standards for prompt processing, submission and acceptance for clearing of swaps eligible for clearing. Such uniform standards, similar to the practices in the futures markets, lower risk because they allow market participants to get the prompt benefit of clearing rather than having to first enter into a bilateral transaction that would subsequently be moved into a clearinghouse.

Third, the final rule does so by allowing asset managers to allocate bunched orders for swaps consistent with long established rules for allocating bunched orders for futures. This will help promote access to clearing of swaps for pension funds, mutual funds and other clients of asset managers.

Lastly, the final rule does so by strengthening the risk management procedures of clearing members. One of the primary goals of the Dodd-Frank Act was to reduce the risk that swaps pose to the economy. The final rule would require clearing members that are FCMs, Swap Dealers, and major swap participants to establish risk-based limits on their customer and house accounts. The rule also would require clearing members to establish procedures to, amongst other provisions, evaluate their ability to meet margin requirements, as well as liquidate positions as needed. These risk filters and procedures would help secure the financial integrity of the markets and the clearing system.