

September 30, 2011

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

**Re: RIN 3038–AD51 - Notice of Proposed Rulemaking - Customer Clearing Documentation and Timing of Acceptance for Clearing (76 Fed. Reg. 45730)**

Dear Mr. Stawick:

The International Swaps and Derivatives Association, Inc. (“ISDA”) and the Futures Industry Association (“FIA”, and together with ISDA, the “Associations”) are writing in response to the proposed rule issued by the Commodity Futures Trading Commission (the “CFTC” or the “Commission”) regarding (i) documentation between a customer and a futures commission merchant (“FCM”) that clears on behalf of the customer; (ii) the arrangement between a customer and a swap dealer or major swap participant that execute a swap with the customer that is intended to be cleared; and (iii) the timing of acceptance or rejection of trades for clearing by derivatives clearing organizations (“DCOs”) and clearing members (the “Proposed Rule”).<sup>1</sup>

We appreciate the Commission’s efforts to build a regulatory framework that promotes the establishment of a sound clearing framework. ISDA and FIA fully endorse the use of central clearing to reduce systemic risk and agree that open access to clearing by market participants is important. We further agree that a principal goal should be establishing a clearing paradigm where, at the time of execution of a trade, as much certainty as possible that the trade will be accepted for clearing is provided to transacting parties and the determination as to whether the trade is accepted or rejected for clearing occurs in real time whether it relies on a method that performs this function pre-execution, immediately upon or following execution, or a combination thereof (“clearing certainty”).

At the Commission hearing adopting the Proposed Rule, Commissioner O’Malia noted that the development of a cleared swap market is a “complicated process” while also expressing

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<sup>1</sup> 76 Fed. Reg. 45730 (August 1, 2011).

his preference for public roundtables and Commission meetings prior to the development of rules in this space. We agree with both Commissioner O’Malia’s observation and suggestion. Given the complexity of the issues involved and the wide range of divergent viewpoints concerning the current state and capabilities of the swap clearing market, we strongly urge the Commission to examine these issues and viewpoints prior to promulgating rules governing customer clearing documentation, the arrangement between a customer and a swap dealer or major swap participant that executes a swap with the customer that is intended to be cleared and the timing of acceptance of trades for clearing.

Our comments are organized as follows:

- The first section provides an overview of industry work to facilitate client clearing through standardizing clearing execution documentation, including the drafting of version 1 of the FIA/ISDA Cleared Derivatives Execution Agreement (“Agreement”), and on-going work to build market infrastructure for the execution and clearing of swaps in the United States pursuant to the Dodd-Frank Act.
- The second section recommends that the Commission examine the current state of clearing and consider the disparate market participant viewpoints regarding the capability of such clearing infrastructure to adequately address market participant concerns.

#### I. Industry Efforts to Facilitate Client Clearing

ISDA’s leadership in facilitating client clearing predates the passage of the Dodd-Frank Act. Through a collaborative effort with the OTC Derivatives Supervisors’ Group (“ODSG”), in June 2009 certain sell-side and buy-side institutions committed to provide client access to CDS clearing with customer initial margin segregation and portability of customer transactions by December 15, 2009.<sup>2</sup> A key step in satisfying this commitment was the publication of the ISDA Recommended Common Principles for Relationships between Customer and Executing Broker and Clearing Member (“Recommended Common Principles”) in November 2009, which is intended to facilitate negotiation of relevant agreements in the context of different clearing platforms.<sup>3</sup>

In addition, prior to the passage of the Dodd-Frank Act, a group of buy-side and sell-side institutions, as well as the CME, met for the purpose of developing OTC clearing documentation for the CME’s CDS clearing platform (which, at that time, was the only FCM model). The group developed a CME OTC clearing derivatives addendum as well as an OTC give-up/execution agreement. The FIA later determined that the industry should have a give-up/execution

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<sup>2</sup> The commitment letter is available at [http://www.newyorkfed.org/markets/otc\\_derivatives\\_supervisors\\_group.html](http://www.newyorkfed.org/markets/otc_derivatives_supervisors_group.html).

<sup>3</sup> The Recommended Common Principles are available at <http://www2.isda.org/asset-classes/credit-derivatives/>.

agreement that covered all CCPs and cleared OTC products. This initiative leveraged off of the CME OTC give-up/execution agreement. This effort merged with ISDA's efforts and resulted in an inter-industry group comprised of over 60 market participants including dealers, FCMs, prospective customers and clearing houses ("Drafting Group") who released version 1 of the Agreement in June 2011. This group also continues to work on a standard OTC derivatives clearing addendum and anticipates finalizing it soon.

The principal focus of the Agreement is to allocate responsibilities for confirming and submitting trades for clearing and establish the rights and obligations of the executing parties in the event of the failure of a trade to be cleared (i.e., rejected by either the clearing member or the clearinghouse). To increase the likelihood that a trade clears, the Agreement, among other things, ensures that each party to a swap that is intended to be cleared establishes clearing arrangements and allocates specific responsibilities in processing and submitting trades that are intended to be cleared. As an option to mitigate risks posed by a failure to clear a trade that is executed with the intention that it will be cleared, the Agreement also includes an *optional* annex ("Annex") that, if both parties agree to apply it, would require one or both of the parties' clearing members ("FCMs") to be a party to the Agreement. Through the Annex, the FCM will notify the other parties of the conditions under which each FCM is obligated to accept the trade for clearing and assume joint and several responsibility with the FCM's customer for damages that might result from the FCM's failure to clear that customer's trade.

As noted, although the Agreement and Annex are strictly voluntary, the Drafting Group responsible for drafting and ultimately approving publication of the Agreement included an accompanying memorandum ("Memorandum") that further affirms that:

- the Agreement is not necessary or appropriate under all circumstances;
- the Annex is optional and therefore is not required to be made part of the Agreement unless the parties mutually agree to do so;
- execution of the Agreement (or the Annex thereto) should not be considered by clearing members to be a condition to the clearing of transactions, although execution parties may request that a form of the Agreement be executed as a condition to executing transactions intended to be cleared; and
- the market and applicable law with respect to cleared swaps is still evolving and therefore may result in further modification of the Agreement, including the Annex, as the market and applicable law deems appropriate and/or necessary.

To advance the transition to a cleared market, upon publication of the Memorandum and Agreement, buy-side and sell-side Drafting Group participants arranged for a series of meetings with the ultimate goal of identifying principles and themes that reflect the broader industry's views as to how market infrastructure for the execution and clearing of swaps in the United

States should develop (“FIA/ISDA Working Group”).<sup>4</sup> The FIA/ISDA Working Group aims to proactively promote market infrastructure development by, among other things, investigating how to maximize the efficiency of trade processing flows from the point of execution to the point of acceptance for clearing and analyzing where credit limits may be housed and the costs and benefits of different approaches.

The Agreement was the result of several months of highly technical and intense discussions during which Drafting Group participants’ utilized significant resources and expertise in attempting to reach a flexible solution that addressed disparate market participant concerns. The work undertaken by the FIA/ISDA Working Group continues to provide a forum for industry discussion, education and market infrastructure development. We believe that industry-driven solutions crafted by product experts have resulted in significant improvements in the infrastructure, trade processing efficiency and mitigation of operational risks in the derivative markets in the recent past<sup>5</sup>, and should play an important part in complementing the Commission’s ongoing development of the supervisory framework established by the Dodd-Frank Act. Deeming certain aspects of the Agreement to be in violation of the Dodd-Frank Act, however, in a Proposed Rule published without the benefit of a public roundtable to assess the industry-driven work product, calls into question the viability of industry initiatives to proactively solve for problems and, at worst, will be a disincentive to continued prioritization

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<sup>4</sup> To this end, the FIA/ISDA Working Group met to review existing trading and clearing paradigms to identify processes for immediate post-execution acceptance for clearing, pre-execution clearing guarantees, and processes used to increase certainty in bilateral, non-cleared markets. Further, the FIA/ISDA Working Group developed a series of questions for potential swap execution facilities (“SEFs”) and clearinghouses/central counterparties (“CCPs”) in an effort to better understand current offerings and articulate measures to increase or ensure real time clearing certainty.

In early August, the CCPs gave presentations focusing on the timing of the key steps between execution and CCP acceptance/rejection for clearing under various trade execution paradigms, such as execution on electronic central limit order book platforms or by voice or RFQ. In September, the SEFs provided similar presentations focusing on explaining the trading format offered by the SEF, whether the SEF plans to ensure clearing certainty through “post-execution clearing acceptance” or “pre-execution guaranteed clearing”, CCP connectivity and issues related to establishing and maintaining credit limits.

These presentations will help FIA/ISDA Working Group participants to work collectively, with CCPs, SEFs, and other market stakeholders, to continue to develop clearing solutions that provide for clearing certainty. Importantly, the meetings have allowed market participants the opportunity to offer the SEF and CCP representatives a forum to discuss important topics, including desired functionality and prioritization of issues that need to be addressed. Likewise, the SEF and CCP representatives’ highlighted issues that they suggest would benefit from industry consensus prior to the development of solutions.

<sup>5</sup> The Commission has acknowledged in previous rulemaking releases the effort led by the ODSG pursuant to which market participants (including buy-side participants) regularly set goals and commitments to bring infrastructure, market design and risk management improvements to all OTC derivatives asset classes. The introduction of new CDS market trading conventions aimed at standardizing trading in most single-name products via the “big bang protocol” is a prime example of a successful an industry-driven solution crafted by product experts. The industry is committed to continue to develop industry-driven solutions, such as the substantial efforts made by participants in the swaps market to establish a portfolio reconciliation and collateral dispute resolution process discussed in the ISDA comment letter to the Commission dated February 28, 2011, to aid in the development of the supervisory framework contemplated by the Dodd-Frank Act.

and engagement by market participants. ISDA and FIA, therefore, strongly encourage the Commission to consult with the industry in the future on its initiatives in advance of possible rulemakings in order to give the industry an opportunity to respond to any questions or concerns. This collaborative approach can ensure that the limited resources and time of all interested parties are spent as wisely and productively as possible.

## II. The Proposed Rule

The Proposed Rule is divided into three parts relating to: (i) the documentation between a customer and an FCM that clears on behalf of the customer; (ii) the arrangement between a customer and the swap dealer or major swap participant that enters into a cleared swap with the customer; and (iii) the timing of acceptance or rejection of trades for clearing by DCOs and clearing members.<sup>6</sup> With respect to (i) and (ii), the Commission is proposing §§ 1.72, 23.608, and 39.12(a)(1)(vi), which collectively would serve to prohibit parties' from utilizing the optional Annex to the Agreement.<sup>7</sup>

In the Proposed Rules, the Commission identified concerns that the Annex may be utilized in a way that would be inconsistent with certain principles and tenets of the Dodd-Frank Act.<sup>8</sup> The Commission also notes that the arrangements contemplated by the Annex "potentially conflict with" certain previously proposed rulemakings, such as §§ 1.71(d)(1) and 23.605(d)(1).<sup>9</sup> These previously proposed rules are aimed at prohibiting SDs and MSPs from interfering or attempting to influence the decisions of affiliated FCMs with regard to the provision of clearing services and activities and would prohibit FCMs from permitting them to do so.

As an initial matter, to the extent that the Commission is relying on inconsistency with proposed §§ 1.71(d)(1) and 23.605(d)(1), we reiterate the concerns we expressed in the comment letter filed by ISDA and the FIA together with the Securities Industry and Financial Markets Association ("SIFMA"), dated January 18, 2011 in response to this proposal ("January Comment Letter").<sup>10</sup> In the January Comment Letter, we forwarded our view that the proposed prohibitions and information partitions are far broader than the statutory language supports, erect barriers that

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<sup>6</sup> Proposed Rule at 45731.

<sup>7</sup> The proposed provisions 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." Proposed Rule at 45732.

<sup>8</sup> For example, in the Proposed Rule, the CFTC identified concerns that the Annexes are inconsistent with the Dodd-Frank Act's principles of ensuring that customers have open access to clearing and exchange trading on terms that have a "reasonable relationship to the best terms available." Proposed Rule at 45731-45731.

<sup>9</sup> Id at 45732.

<sup>10</sup> The joint comment letter from ISDA, FIA and SIFMA to the Commission, dated January 18, 2011, regarding the Commission's notice of proposed rulemaking with respect to the Implementation of Conflicts of Interest Policies and Procedures by Futures Commission Merchants, Introducing Brokers, Swaps Dealers, and Major Swap Participants may be found at <http://www2.isda.org/dodd-frank/>.

disadvantage clients who benefit from the integrated nature of multi-service financial institutions and undermine the ability of the FCM, the SD or MSP to carry out risk management functions. We also provided a more tailored alternative that would address the conflicts identified by Congress in enacting §4s(j)(5) of the CEA and separate clearing personnel at the FCM from “review, pressure or oversight” of those in trading, pricing or clearing activities that would bias their judgment and “contravene the core principles of open access.”

As noted, we fully support establishing a clearing framework grounded in the principles of clearing certainty and open access to clearing for all market participants. To this end, we support Commissioner O’Malia’s suggestion to hold staff roundtables and/or Commission hearings. ISDA and FIA suggest that these meetings examine the market infrastructure for the execution and clearing of swaps. We believe that understanding the current state of such market infrastructure as well as the prospect and timing for development of enhanced market infrastructure is critical to evaluating the risks presented by and appropriate documentation for swaps trading and clearing. We encourage the Commission to closely examine the obligations imposed on each party to the Agreement<sup>11</sup> and consider how the Proposed Rules may interact with other Commission rules that impose duties on market participants.<sup>12</sup> Lastly, as the market considers questions related to the administration of the “trilateral” arrangement, we also encourage the Commission to work with industry to examine how the Agreement and Annex may work in practice.

We agree with the Commission’s belief 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.”<sup>13</sup> Our experience suggests, however, that market participants maintain a wide range of views regarding the current state and capability of swap clearing infrastructure to achieve these goals in the near term. As discussed above, however, the FIA/ISDA working group CCP and SEF sessions are building a broader base of common understanding of infrastructure

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<sup>11</sup> For example, the Proposed Rule states that, “concerns arise in connection with certain provisions that would permit a customer’s FCM, in consultation with the SD, to establish specific credit limits for the customer’s swap transactions with the SD, and to declare that with regard to trades with that SD, the FCM will *only* accept for clearing those transactions that fall within these specific limits.” (emphasis added) However, the Agreement does not limit an FCM to accept for clearing only those transactions that fall within these specific limits but rather provides the FCM with the option to accept or reject those trades that fall outside the limits.

<sup>12</sup> For example, pursuant to the Commission’s proposed rulemaking regarding Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants (75 Fed. Reg. 71397 (Nov. 23, 2010)), swap dealers and major swap participants will be required to have risk management procedures and monitor risk exposures with respect to both cleared and uncleared swap positions. Without clearing certainty, there is less assurance prior to execution that a swap that is intended to be cleared by the parties will be actually cleared. If such a swap is not cleared, then the swap dealer or major swap participant may have bilateral counterparty risk to the extent that the swap dealer or major swap participant elects for a bilateral trade between the executing parties and such bilateral trade is permitted by applicable law and the rules of the trading venue, if any, or in collecting breakage costs, if any. In such an environment, practical questions arise as to how the swap dealer or major swap participant will be able to comply with the proposed risk management requirements if it is not certain at the time of execution whether the swap will be cleared (where the risk exposure is to the clearinghouse) or uncleared (where the risk exposure is to customer).

<sup>13</sup> Proposed Rule at 45734.

readiness, and the industry intends to leverage the FIA/ISDA Working Group platform to investigate the offerings for various clearing solutions that provide for clearing certainty and to consider questions related to the administration of execution arrangements and agreements. We likewise urge the Commission to examine the current state of the cleared swaps market and consider the disparate market participant viewpoints regarding the capability of such clearing infrastructure to adequately address market participant concerns prior to determining final rules for cleared swap documentation.

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We appreciate the opportunity to provide these comments. Please do not hesitate to contact the undersigned or our staffs if you have any questions.

Very truly yours,



Robert Pickel  
Executive Vice President, ISDA



John M. Damgard  
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