



SWAPS & DERIVATIVES MARKET ASSOCIATION

April 19, 2011

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

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

Re: OTC Derivative Market Integrity & Real-time Trade Processing
Requirements for Processing, Clearing, and Transfer of
Customer Positions 17 CFR Parts 23, 37, 38 and 39, RIN 3038-AC98

Dear Mr. Stawick and Ms. Murphy:

The Swaps & Derivatives Market Association (“SDMA”) appreciates the opportunity to provide comments to the Commodity Futures Trading Commission (the “CFTC”) and the Securities and Exchange Commission (“SEC”) (CFTC and SEC collectively the “Commissions”) on the CFTC’s Notice of Proposed Rulemaking regarding Parts 23, 37, 38 and 39 of Title 17 of the Code of Federal Regulation entitled “Requirements for Processing, Clearing, and Transfer of Customer Positions”.

The SDMA is a non-profit financial markets trade group of US and internationally based broker-dealers, investment banks, futures commission merchants and asset managers participating in all segments of the exchange-traded and over-the-counter derivatives and securities markets.

The immediate real-time clearing of swaps¹ is critical to accomplishing the goals of the Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd Frank Act”) to: (1) reduce systemic risk, (2) increase trade integrity and (3) promote market stability.

The SDMA supports the amendments to proposed rules 23.506 “Swap Processing and Clearing”; 37.702 “General Financial Integrity”, 38.61 “Mandatory Clearing” and 39.12 “Participant and Product Eligibility”. Specifically, we support them because these amendments certify a regulatory framework that provides for real-time clearing of swaps traded on swap execution facilities (“SEFs”) or designated contract markets (“DCMs”) that are listed for clearing by central counterparty clearing houses (“CCPs”)².

The SDMA believes that in order to have successful clearing and SEF-based execution of OTC derivatives, it is critical that there be certainty of execution and trade settlement. Such certainty is clearly a function of pre-trade and post-trade trade integrity. For the reasons stated below, the SDMA recommends that the Commissions mandate the use of existing and commonly available financial technology and symmetrical workflow that brings: (1) post-trade trade integrity through immediate real-time clearing, and (2) the pre-trade trade integrity through immediate and real-time pre-trade margin checks. Both are necessary complimentary components to ensure that market integrity in the cleared swaps market created by the Dodd Frank Act is achieved.

I. Post-Trade Trade Integrity

The buyer and seller must know immediately whether their trade has been accepted for clearing. Trade uncertainty, caused by the time delay between the time of trade execution and

¹ Throughout this letter all references to “swaps” refers to swaps and security-based swaps that are required to be cleared by Sections 723 and 763, respectively, of the Dodd Frank Act.

² The CFTC refers to the clearing house as derivatives clearing organization or “DCO”, and their clearing members as Futures Commission Merchants or “FCMs”. The SEC refers to the clearing house as a Security-Based Swap Clearing Agency and their clearing members as Clearing Agency Participants. For the purposes of this letter we will refer to the clearing house as the central counterparty clearing house or “CCP” and their members/participants as clearing firms.

the time of trade acceptance into clearing³, destroys market integrity in the post-trade work process. It also directly impedes liquidity, efficiency, and more stable markets. The SDMA recommends two solutions to promote post-trade trade integrity and prevent such trade uncertainty.

Certain Cleared Listed Markets: FCMs Guarantee Customer Trades

First, the SDMA believes that for cleared OTC derivatives markets, the Commissions should follow the construct of certain futures markets where “perfect settlement” of a trade is assumed unless the trade is rejected. In these futures markets, clearing member firms, or Futures Commission Merchants (“FCMs”), guarantee their customer trades. That is to say, the trade is executed and is automatically confirmed unless the clearing member has given prior notice to reject such a trade. Trade integrity is assured and settlement risk minimized because the trade counterparty can look to the customer’s FCM to be made whole if that customer cannot pay.

Such an optimal approach works well in the futures markets because the onus falls on the entity best positioned to monitor a market participant’s ability to pay for its trade — the participants’ FCM. The FCM strictly and proactively monitors its customer’s margin and trading parameters to protect itself and, by extension, trade counterparties from a rejected trade where economic loss could be experienced. Similarly, if the FCM seeks to limit the trading of its customer, the FCM is required to inform the execution broker or trade venue of such a restriction in advance. Because it holds the customer’s margin account, the FCM is best positioned to inform trade venues to limit a customer’s trading. FCMs are also optimally positioned to require additional funds or liquidate a position in order to cover any breakage amounts or cover any expenses it may have incurred from a customer’s rejected trade.

Because this approach has worked well for many years, it provides a good example for similarly structuring the cleared swaps market created by the Dodd Frank Act.

³ Currently in the OTC market the time delay between trade execution and clearing can be anywhere from several hours and a week.

Cleared OTC Derivative Market: The “Last Look” Option and its Remedy

Currently in the fledgling cleared OTC swaps market, clearing members do not guarantee trades and thus such workflow requires that a trade be “accepted” post execution before it is confirmed for clearing. It is foreseeable that, although clearing firms expect to routinely accept customer trades, such an option to reject a customer trade post execution represents a “last look” option that may lessen trade integrity if not addressed.

The SDMA recommends that if the “last look” option is to become the market standard in the cleared OTC swaps market, then the only remedy for a rejected trade is that the trade be broken — that is, there is no trade.

Breaking a rejected trade in the OTC swaps market should not be viewed as negative. Rather, it is the optimal solution preferred by many buy-side and dealer participants, if “no trade” is coupled with “real time” or immediate notification to the trade counterparties. If the parties are notified in real time, economic loss is minimized as it is assumed that the market may have moved little and thus “breakage” or the cost of executing a new trade to replace the rejected trade is minimized. “Good” trade counterparties can re-enter the market immediately to execute new trades with solvent counterparties that are accepted into clearing. In contrast, “bad” trade counterparties are restricted by both the SEF and their clearing firm from executing further trades.

To ensure post-trade trade integrity, the SDMA strongly urges that the Commissions require that SEFs, CCPs and clearing members utilize current and available technology and symmetrical workflow to ensure real-time trade confirmation. Regulators should require that (1) all SEFs deliver both sides of the trade simultaneously to the CCP in real time; (2) CCPs respond with the trade acceptance or rejection in real-time back to the SEF, such that the SEF can in turn immediately notify the trade counterparties; and (3) CCPs work with their member clearing firms to ensure that it provide and maintain the internal workflow and technological infrastructure necessary to make certain that the CCP can respond to the SEF in real time.

Importantly, swap CCPs should be cognizant that their swap workflows might actually impede real-time confirmation. Certain CCPs do not offer a direct application program interface (“API”) connectivity through which a SEF can directly connect to confirm trades. Instead, these swap CCPs offer connectivity and trade confirmation only via third party *middleware* systems. By adding extra steps, these CCPs may be increasing communication latency which could add trade uncertainty if not addressed.

The SDMA’s solution that views rejected trades in real-time as “no trades” recognizes a practical construct that has existed in the cleared derivatives market since its inception. It recognizes that clearing houses (and their clearing members) should work in concert with execution venues to optimize trade and settlement integrity. SEFs and CCPs should seek to bring execution closer to clearing by lessening trade confirmation latency to the point of real-time settlement in the workflow. It is important to note, that certain applicant SEFs and forward thinking OTC swap clearing houses either offer now or expect to offer such real time, low latency connectivity as the Dodd Frank Act becomes effective in the coming months.

II. Pre-Trade Trade Integrity

During the course of trading, buyers and sellers may knowingly or unknowingly exceed their margin parameters (set by their clearing broker) which may result in a trade being rejected for clearing. The uncertainty that a buyer or seller may have exceeded its margin parameters, and potentially cause a trade to be rejected for clearing, has an adverse impact on pre-trade trade integrity and increases settlement risk.

To further mitigate such risk, the SDMA recommends that the Commissions compel market participants to take a definitive, proactive approach to enhancing trade integrity on a pre-trade basis. The Commissions should require that pre-trade customer margin checks occur at the SEF to protect the market from a customer who either knowingly or unknowingly violates margin parameters by initiating a trade that will be rejected.

Specifically, regulators should require clearing firms to share customer margin information via CCP connectivity with SEFs on an immediate or real-time basis. To avoid building additional

connectivity directly between multiple SEFs and multiple clearing brokers, it is optimal that the CCP be the central *nexus* where such information is exchanged. SEFs, which operate in a neutral capacity for the customer, can transmit such information back to the customer so that it does not knowingly breach its own trading parameters within a given clearing house. Importantly, through such workflow customer anonymity is preserved as customers see only their own margin information.

To further promote pre-trade trade integrity, regulators should require SEFs to monitor such customer margin parameters to prevent a customer from either knowingly or unknowingly trading beyond its limit by restricting the customer's execution ability before an offending trade occurs.

By linking execution venues with customer spending power on a real-time pre-trade basis, customers are precluded from executing trades that would ultimately be rejected. SEFs and clearing firms can communicate real-time on their customers via CCPs such that the customer's trading experience dramatically improves. As trade rejection frequency diminishes, so too does settlement risk. Importantly, trade certainty and marketplace integrity increase, though not at the expense of customer anonymity.

To act as a deterrent, SEFs and CCPs should be allowed to impose sanctions and fines on customers who knowingly breach their limits. At a higher level, regulators should also look to impose fines or take more punitive action on such customers for such careless activity.

It is important to note, that the technology needed to support pre-trade margin checks exists today and is being deployed by certain CCPs and SEF execution venues.

III. Alternative Documentation and Workflow Proposals

Some have suggested that trade integrity and settlement risk can be mitigated through documentation or asymmetric workflow. Specifically, certain parties have suggested that if a trade is rejected from clearing, the trade is still "good" because it can become a non-cleared,

bilateral trade governed by a traditional ISDA Master Agreement (“ISDA Agreement”) signed by the buyer and the seller.

The SDMA adamantly believes that this solution is unworkable. If a trade is rejected for clearing, “falling back” to an ISDA Agreement is not viable for several reasons. First, a bilateral trade has higher capital costs than a cleared trade. Second, a bilateral trade introduces counterparty credit risk that was not present for the original cleared trade. Increasing capital costs and exposing the parties to direct credit risk were not bargained for by the parties when they originally initiated, what they thought was to be, a cleared trade. These are material changes to the terms of the trade that warrant a new price or “market” to which the parties must now agree. By changing the trade terms, price included, it is in fact a new trade and the original rejected trade should be broken.

Moreover, suggesting that a cleared trade may exist in an uncleared, bilateral state contravenes the express language of the Dodd Frank Act. Sections 723 and 763 of the Dodd Frank Act are clear. These sections provide that it is unlawful for any person to engage in a swap or security-based swap unless that person submits such swap or security based swap for clearing to a CCP, if the swap is required to be cleared.

Interestingly enough, requiring the use of an ISDA Agreement to save a trade that has not been accepted for clearing does not escape the obvious fact that the bad counterparty still cannot pay for the trade. In practice, trades are rejected not because the offending counterparty cannot pay for the trade same day. It is because the counterparty’s clearing broker reasonably expects that the offending counterparty will not be able to pay for the trade next day or any day thereafter. To somehow force a counterparty into a bilateral trade with a non credit worthy counterparty seems an unfair cure that benefits the offending counterparty at the direct expense of the compliant counterparty. Importantly, having an ISDA Agreement in place with an insolvent counterparty does not improve a counterparty’s chance of getting paid on the trade.

Lastly, “falling back” to an ISDA Agreement would restrict trading and adversely affect liquidity, as it limits buyers and sellers to trading only with counterparties with whom they have ISDA

Agreements in place. Therefore, this restricts trading by (1) eliminating the viability of the “all to all” platforms – since you must have an underlying ISDA Agreement to trade with a counterparty to ensure the “fall back” procedure holds; and (2) eliminating the anonymity that the buy-side desires in the post Dodd Frank market place.

For these reasons, the SDMA believes that having an ISDA “fall back” provision does little to lessen settlement risk and may actually increase it.

Still other market groups have suggested other documentation for the market to adopt that memorializes an asymmetric workflow that not only increases trade latency but limits customer choice and access to liquidity. These parties have suggested that a trade may only be submitted to clearing by a *self-clearing* dealer. That is, the dealer submits the trade to clearing on it's and the customer's behalf. In other words, SEFs are forbidden from neutrally submitting “buyside” and “sellside” trade legs simultaneously, quickly and directly to the clearing house. .

Such a requirement that SEFs must submit trades via certain dealers is problematic for several reasons. First, it forces an asymmetric workflow that adds more latency to the post-trade process, thus reducing trade integrity. Second, it forbids *non self-clearing* dealers from submitting trades unless they are a “customer” to the dealing desk of a clearing member, thus effectively denying them access to the marketplace. Third, it is a clear restraint on free trade because it prohibits customers from trading with each other in a cleared “all to all” marketplace clearly envisaged by the Dodd Frank Act. Fourth, it violates customer anonymity as customers are now always known to their dealer counterparties. Fifth, it limits customer choice to all but a few dealers and FCM entities and thus dangerously restricts market liquidity.

As an additional feature to this workflow, these industry parties have suggested an option that clearing firms provide customer margin information directly to a dealer so that it may check the customer on a pre-trade basis. While such a solution sounds similar to the SDMA pre-trade margin check proposal (discussed above), it is fundamentally different. The SDMA recommends that the clearing firm share such information with an independent and neutral

party, acting as agent for both buyer and seller — the SEF, not with an interested party to the transaction — the dealer, acting as principal.

Sharing such information with a principal to the transaction no doubt creates a conflict of interest and is unworkable. It is also contrary to information partition provisions of Sections 731 and 764 of the Dodd Frank Act that preclude FCMs from sharing customer information with their dealer desk counterparts. Moreover operationally, implementing such a decentralized system might prove to be difficult as some have already noted. Separate connectivity would be needed to link each one of several clearing firms to each one of several dealers in a new communications network. As the number of dealers, customers and clearing brokers grew, the system's complexity would increase exponentially. Such a system might prove so costly for the end user that, in practical terms, they would be forced to operationally connect to all but a handful of dealers, thus limiting their choice and their access to liquidity.

Regulators should be wary of such documentation and workflows that on their face claim to enhance trade certainty and market integrity, but are transparent attempts to restrict trade, customer choice and liquidity. Such proposals only serve to undermine the core principles of the Dodd Frank Act.

IV. Conclusion

The SDMA believes post-trade trade integrity and pre-trade trade integrity are both necessary components to promote market integrity and lessen settlement risk in the cleared swaps market created by Dodd Frank Act. For central clearing to be successful, the Commissions must intervene to require that the market adopt precedents set in other markets and use widely available technology and workflow necessary to create (a) post-trade trade integrity through immediate real-time clearing, and (b) the pre-trade trade integrity through real-time pre-trade margin checks.

The SDMA recommends that the Commissions be vigilant that any proposed workflow not be restrictive or represent an anticompetitive restraint on customer choice of counterparty or

execution method. Nor should it be a restraint on a buyer's or seller's choice of clearing firm. The workflow must provide for a symmetrical post-trade trade submission to clearing by which SEFs simultaneously deliver both customer trade legs real-time to the CCP. CCPs should in turn accept or reject trades for clearing in real-time. Any proposed workflow must increase, not decrease, the speed at which a trade is confirmed for clearing by the CCP. Moreover, any proposed workflow should not be an attempt to circumvent the core principles of the Dodd Frank Act. As a market, all participants under the guidance of the Commissions should be able to work in concert to bring about a solution that is consistent with the Dodd Frank Act and ensures the OTC clearing of swaps is a success.

Submitted Respectfully,



James Cawley
The Swaps & Derivatives Market Association
(646) 588-2003