MEMORANDUM

TO: Title VII Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act

FROM: Cristie L. March, Counsel
Office of the Chairman

DATE: October 3, 2011

SUBJECT: Meeting with Delta Strategy Group

On September 27, 2011, Jim Burns, Jennifer McHugh, Cristie March, Peter Curley, and Haimera Workie met with representatives from Delta Strategy Group to discuss issues related to security-based swap clearing rules and real-time processing. In reference to the above file, attached is the submission Delta Strategy Group provided during the meeting.

Executive Summary

Proposed rules on Customer Clearing Documentation and Timing of Acceptance for Clearing are warranted and beneficial to the market

» The proposed rules are the single most important step towards the launch of clearing with real buy-side access and open and competitive SEF and FCM offerings

» Execution agreements are not required in any other cleared markets

Further, no other cleared market tolerates execution agreements that sacrifice anonymity of execution counterparties, impose sub-limits on trading activity, restrict choice of counterparties, and thereby jeopardize access to best execution

» Proposed rules are justified and required by DFA

DFA requires the CFTC to take action to ensure open access and non-discriminatory clearing and to prevent the restraint of trade or anticompetitive burdens

» Real time acceptance is the best market solution

Ensures clearing certainty, creates an open and level competitive playing field for execution, improves pricing, and maximizes access to liquidity for all participants, large and small, including in periods of stress

» Technology-based solutions will lead to safe and open markets

Real-time clearing with straight-through-processing is the proven means to ensure safe and open markets, rather than a web of credit dependencies built upon execution documentation and designation notices

» No "interim" documentation arrangement is necessary

Straight-through-processing (STP) already exists in other cleared derivatives markets, it would take longer to create an interim framework for sub-limit administration than to finalize the infrastructure necessary for STP for OTC derivatives clearing, and the CFTC's phased implementation plan already provides ample time for the market to make final preparations for STP

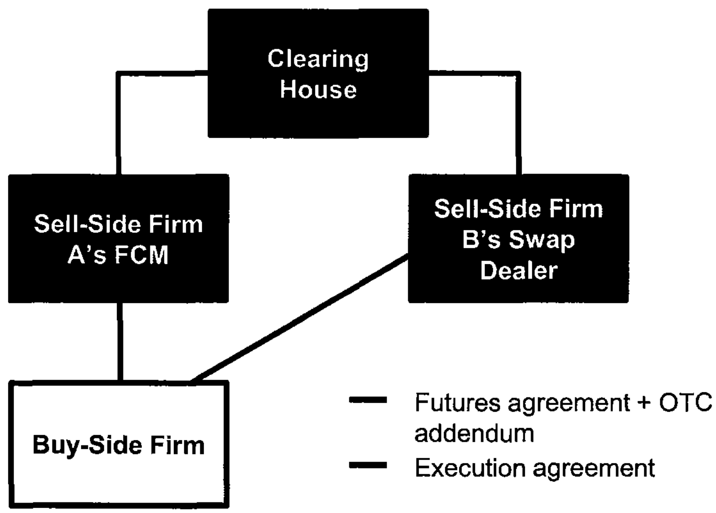
Meanwhile, "interim" arrangements, such as the proposed trilateral execution agreement, will inevitably become permanent, and among others, will prevent electronic execution

Customer Clearing Documentation

While not required in other cleared derivatives markets, execution agreements have been proposed for cleared OTC derivatives

Proposed Bilateral

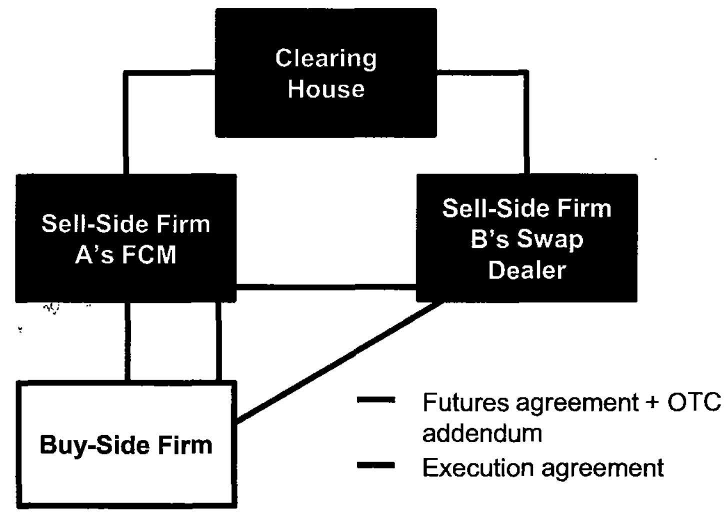
- Two parties to the execution agreement
- One overall credit limit for client
- Open choice of execution counterparties
- Anonymity of client's execution counterparties to FCM



Unnecessary but acceptable if parties desire, since the bilateral does not limit choice of counterparty, and does not reveal counterparty to FCM

Proposed Trilateral

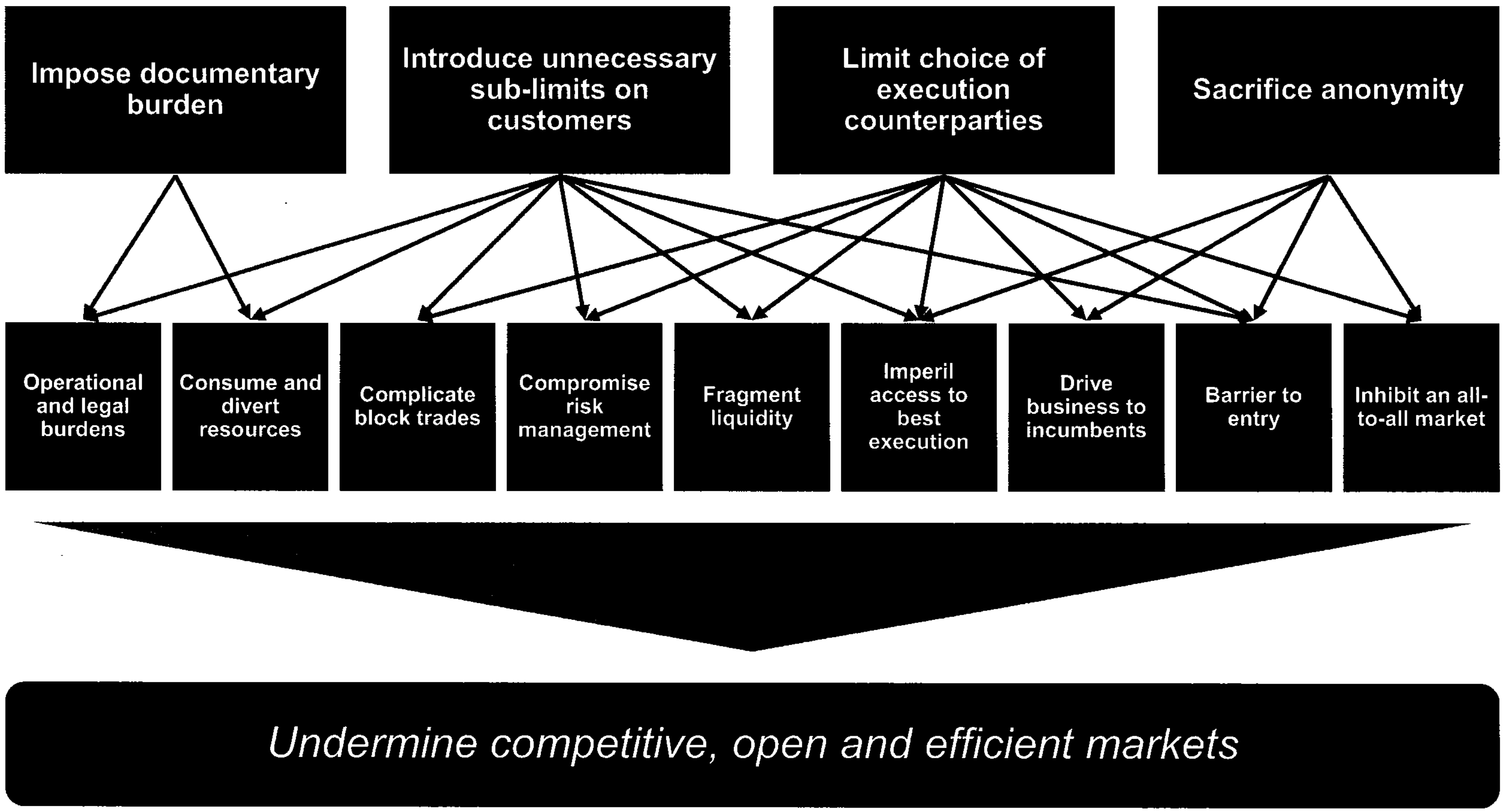
- Three parties to the execution agreement
- Sub-limits for each of the clients' counterparties
- Restricted choice of execution counterparties
- Disclosure of client's execution counterparties to FCM



Unnecessary and unacceptable, since the arrangements provide no incremental benefit and undermine competitive, open and efficient markets

Customer Clearing Documentation

A system built on trilateral execution agreements would have material adverse market consequences



Customer Clearing Documentation

The proposed rule is authorized and warranted by Dodd-Frank

Direct impact of trilateral scheme	Market implications		DFA principles	Specific DFA / CEA provisions or rules
Imposes documentary and administrative burden **Fragments client trading limits (via designation of sub-limits)** **Sacrifices anonymity (exposes identity of client's execution counterparties to its FCM)** **Limits clients' choice of execution counterparties**	Limits choice of counterparties	⇨	Unreasonable restraint of trade	DFA Sec. 731 & §23.607 for SDs / MSPs DFA Sec. 725(c) for DCOs
	Restricts freedom / flexibility to trade, especially in block size	⇨		
	Erects barriers to accessing best bid/offer	⇨		
	Inhibits development of an all-to-all market	⇨		
	Drives business to incumbent swap dealers	⇨	Material anticompetitive burden	DFA Sec. 731 & §23.607 for SDs / MSPs DFA Sec. 725(c) for DCOs
	Disclosure of execution counterparties advantages swap dealer	⇨		
	Perpetuates barriers to entry	⇨		
	Thwarts alternative liquidity providers, and by extension, the price competition and liquidity they would bring to the market	⇨		
	Potential for swap dealer to influence clearing-related decisions • List of permissible trilateral execution counterparties • How limits are allocated, administered, and adjusted	⇨	Biasing judgment	CEA Sec. 4s(j)(5) for SDs / MSPs CEA 4d(c) for FCMs
	Ensures clearing services are not offered to a competing non-incumbent swap dealer on economic terms (if at all)	⇨		
	Prejudices certain modes of execution (RFQ vs. CLOB)	⇨	Contravene open access / Violates non-discriminatory clearing	CEA Sec. 4s(j)(5) for SDs / MSPs CEA 4d(c) for FCMs CEA Sec. 2(h)(1)(B)(ii)
	Restricts availability of clearing to market participants who do not subscribe to "voluntary" trilateral agreements	⇨		
	Limits choice of counterparties	⇨	Limits access to "best execution"[1]	DFA Sec. 731 & §155.7 for SDs / MSPs
	Drives business to incumbent swap dealers	⇨		
	Thwarts alternative liquidity providers, and by extension, the price competition and liquidity they would bring to the market	⇨		
	Inhibits development of all-to-all-market	⇨		
	Restricts freedom / flexibility to trade, especially in block size	⇨		

Notes: 1. Referred to in §155.7 as "reasonable relationship to the best terms available"

Timing of Acceptance for Clearing

Real time acceptance is the proven market solution

» By eliminating counterparty credit risk concerns, clearing allows participants in cleared markets to **transact without barriers** with all other eligible market participants

» This creates an **open and level competitive playing field** for execution, improves pricing, and maximizes access to liquidity for all participants, large and small, even in periods of stress

» Real-time acceptance of trades for clearing is **economically viable and technologically feasible**, as established by a wide range of robust existing cleared markets for derivatives

» All offerings for cleared OTC derivatives in both **CDS and IRS are prepared to provide real-time acceptance** for clearing

» Clearing certainty – the immediate knowledge that a trade has been accepted for clearing or not – means that **no damage is suffered if a trade is rejected** (rather, the trade never happened and no time has passed)

» Real-time acceptance for clearing thus **eliminates the need for execution agreements** that seek to quantify and allocate damages, and use intermediation to allocate risks when trades are not accepted for clearing

» The alternative – maintaining a window of counterparty credit risk between execution and clearing that then would warrant credit intermediation – undercuts clearing's positive impact on systemic risk abatement, as well as competition, pricing and liquidity

Timing of Acceptance for Clearing

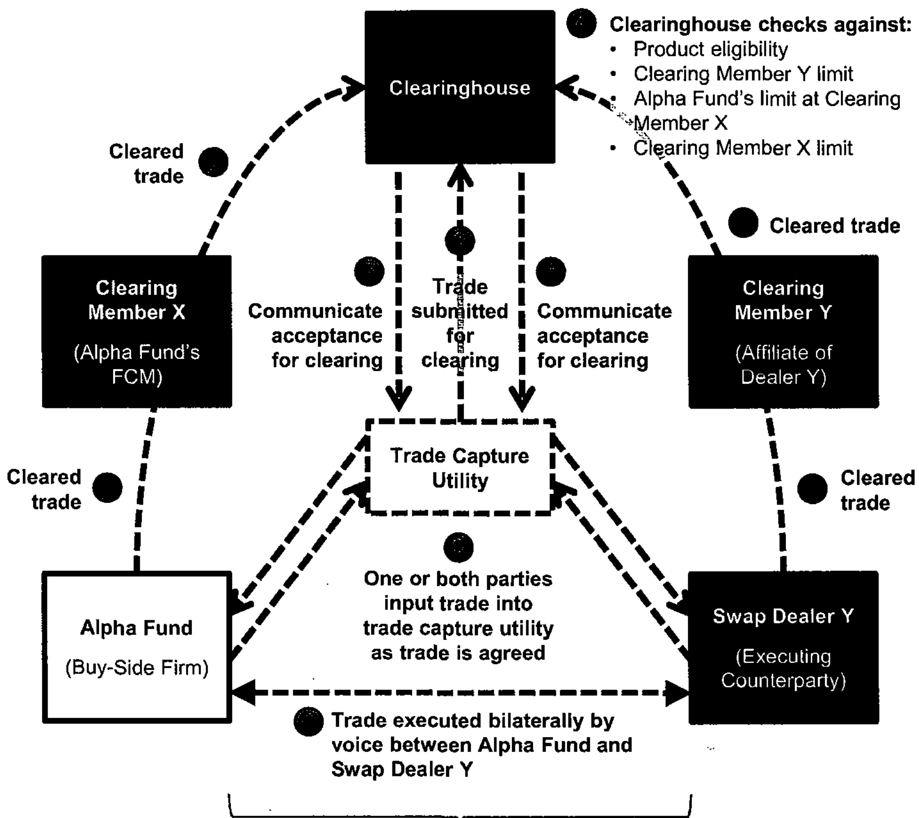
Market benefits of real time acceptance

- **Ensures clearing certainty** [redacted]
- **Eliminates counterparty credit risk** [redacted]
- **Improves pricing and access to best execution** [redacted]
- **Fosters competition** [redacted]
- **Improves market liquidity** [redacted]
- **Relieves documentary burden**
- **Enhances reporting and transparency**

Timing of Acceptance for Clearing

Real-time automation of the validation process for clearing acceptance

Indicative workflow for cleared trade…



The process would be streamlined even further for SEF-executed trades , where steps 1 and 2 would effectively be combined.

… with automated validation

» Clearinghouses, clearing members, and other relevant market infrastructure providers, are able to automate this process flow in real-time

» Key step is the validation performed by the clearinghouse prior to acceptance (see ●), and key to this validation is the customer limit check. CFTC proposed rule summarizes 3 options for the customer limit check:

  » *Pre-trade (essential to support central limit order book)*: Screening utilities based on predetermined criteria with credit and product filters that apply automatically

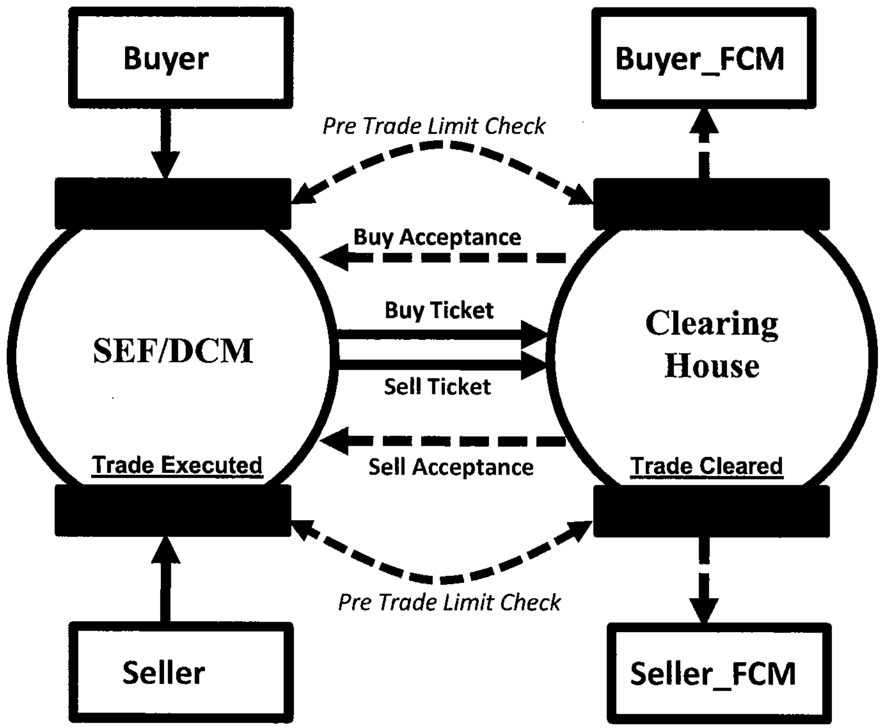
  » *Post-trade, at DCO*: Clearing member authorizes DCO to screen trades on its behalf and to accept or reject according to criteria set by the clearing member

  » *Post-trade, at FCM*: Messaging from the clearinghouse to the clearing member for each trade requesting acceptance or rejection, followed by reply message

» Each approach can be done in real time.

Timing of Acceptance for Clearing

Low latency solution



FCM: Last Look Option

Post Trade Process:

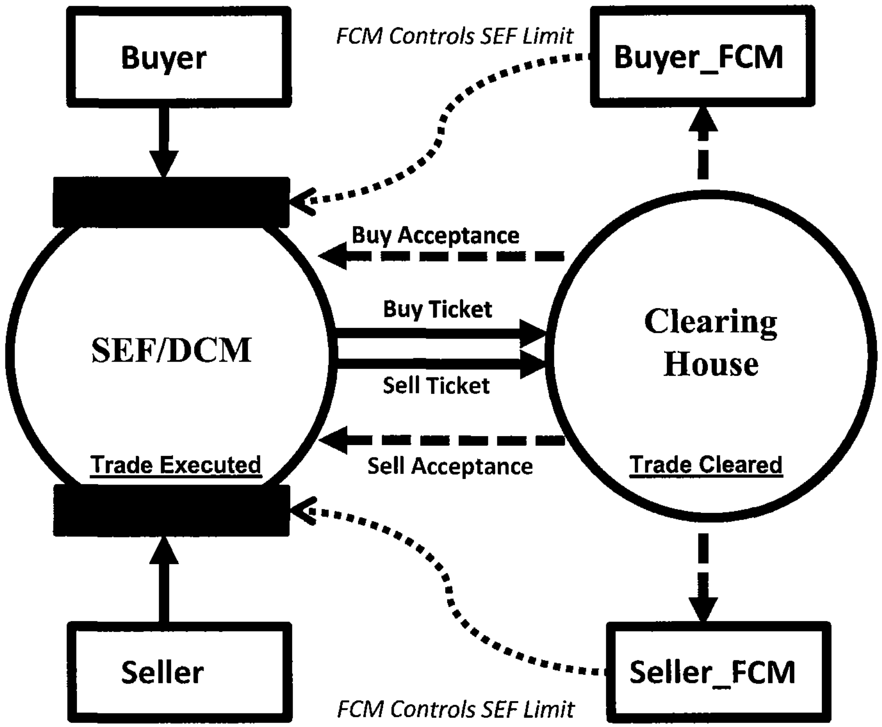
1. Trade Executed On SEF between Buyer & Seller.
2. Trade Sent to CCP (milliseconds).
3. Trade Checked via FCM Pre-Set Customer Limit at CCP (milliseconds).
4. FCM may vary Pre-Set Customer Limit at CCP real time; exists today).
5. Trade Acceptance/Rejection Noticed back to SEF (on SEF) or Buyer/Seller (off SEF) (milliseconds).

Pre Trade Process:

1. To protect from Customer from knowingly exceeding limit
   - SEF screens order against Pre-Set Customer Limit.
   - CCP either makes Limit available to SEF or SEF queries data held at CCP.
2. To protect from Customer unknowingly exceeding limit:
   - SEF notices Customer real time of current 'spending power' on User Interface or via API.
   - SEF institutes various 'fat finger' checks.

Note: Clearport uses similar model

Timing of Acceptance for Clearing
Perfect settlement



FCM: No Last Look Option

Post Trade Process:

1. Trade Executed On SEF between Buyer & Seller.
2. Trade Sent to CCP (milliseconds).
3. Trade Acceptance by CCP & FCM automatic.

Pre Trade Process:

1. SEF notices customer real time of current 'spending power' on User Interface or API.
2. SEF institutes various 'fat finger' checks.
3. FCM directly monitors its customer orders on SEF.
4. FCM directly controls its customer limit directly on SEF.
5. FCM can cut customer off/dial limit down real time. (Prevents bad trades from occurring at source.)

Important:

1. FCM guarantees its customer trade.
2. Burden on FCM to police customer on SEF(s).
3. FCM is nexus to credit decision--best able to monitor customer across SEF
4. By protecting itself from bad trade, it protects market.
5. FCM best able to collect against customer (can liquidate account).

Note: Globex uses this model.

Addressing Common Myths (1/2)

Myth 1: Access for smaller buy-side firms

Facts

- FCMs necessarily retain the right to unilaterally reduce a client's limit at any point, so "guarantee" is worth little
- Real-time acceptance is the secure means to ensure that small firms can access all liquidity providers
- Constraints on market access and range of execution counterparties far outweigh any perceived benefits of having an FCM "provisionally guarantee" clearing capacity
- Trilaterals never used in other cleared markets where small firms [illegible]

Myth 2: Certainty during stressed or volatile conditions

Facts

- FCMs have the right to reduce a customer's limit at any time
- Trilaterals thus do not provide any firm assurance in times when the customer is experiencing financial stress or there is high market volatility

Myth 3: Risk management

Facts – General

- Real-time acceptance for clearing gives certainty to everyone, and certainty is far superior to contractual remedies to recover breakage fees

Facts – FCMs

- FCMs closely monitor the limits provided to each customer and are free to (a) reduce those limits at any time and (b) reject trades that would breach them
- FCMs have never managed to counterparty specific sub-limits, have no systems to do so and generally do not want to take this risk
- [illegible]

Facts – Clearinghouses

- Clearinghouses are able to manage the risk of accepting trades for clearing immediately, even if margin moves the next day, because:
  - They are exposed to FCMs, not directly to customers
  - They actively monitor the credit of their limited universe of FCMs and have power to call for additional margin or set risk reducing parameters
  - FCM [illegible]

Myth 4: Asset manager allocations

Facts

- Trilaterals do not solve the allocation issue faced by multi-account asset managers
- Clearing certainty during this "allocation window" will rather be solved by a standby clearing guarantee from a principal FCM, a mechanism long established in futures
- Having a "standby" clearing member guarantee acceptance for clearing of the bunched trade before it has fully [illegible]
- Enabling immediate acceptance of the bunched trade allows best execution for the asset manager, whereas trilaterals tie clearing with execution
- The customer's agreement with the clearing member to accept the risk of the larger trade for the brief period before the risk is divided up among the relevant funds allows the customer to execute [illegible]

Addressing Common Myths (2/2)

Myth 5: Technological feasibility

Facts

- Real-time acceptance for clearing is already provided operationally by a number of clearinghouses for a range of cleared derivatives including futures, listed equity options, and energy swaps
- Investing industry efforts in ironing out the final and well understood hurdles to real-time acceptance fosters DFA objectives, rather than spending money on the administration of sub-limits under [illegible]

Myth 5: Trilateral agreements are optional

Facts

- Absent a prohibition, the trilateral execution agreement will be forced on the market
- Few buy side players have the leverage / bargaining power vis-à-vis swap dealers to object to the trilateral execution agreements
- Largest swap dealers say they will tie bid-offer pricing to use of the trilateral

Myth 6: Trilateral agreement represents an industry consensus

Facts

- Not an industry consensus product – rather, significant buy side unanswered questions and reservations were not addressed before the drafts were published, and remain open
- Document itself is replete with health warnings – "optional", "not required", will almost certainly be superseded, "not a condition to clearing", etc.

Myth 7: CFTC authority to act

Facts

- CFTC is compelled to act in order to uphold DFA principles related to "Unreasonable restraint of trade", "Material anticompetitive burden", "Conflicts of interest", "Open access", "Non discriminatory clearing", and "Best execution" (see slide 4)
- CFTC is instructed to adopt rules governing the documentation standards for swap dealers (DFA Sec. 731), including execution agreements
- A stated goal of the Dodd-Frank Act is to "promote the trading of swaps on swap execution facilities" (DFA Sec. 733). The Proposed Rules are essential to achieving this goal since the clearing certainty that real-time acceptance provides is a pre-requisite to market participants [illegible]