



August 5, 2012

**Via Electronic Submission:** [www.esma.europa.eu](http://www.esma.europa.eu)

European Securities and Markets Authority  
103 Rue de Grenelle  
75007 Paris France

**Re: MFA Accompanying Letter to the MFA Comment Letter in Response to ESMA Consultation Paper on Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories regarding Straight-Through-Processing**

Dear Sir or Madam:

Managed Funds Association<sup>1</sup> appreciates the opportunity to submit, in conjunction with MFA's separate and concurrent response to ESMA's Consultation Paper on "Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories" (the "**Consultation Paper**")<sup>2</sup>, accompanying comments to the European Securities and Markets Authority ("ESMA") on the benefits of straight-through-processing (referred to interchangeably herein as "**STP**" or "**straight-through-processing**"), as MFA discussed in the ESMA hearing in Paris on July 12, 2012, and the legal basis for ESMA's authority to draft regulatory technical standards ("**RTS**") under Article 11(14)(a) EMIR in relation to STP. Throughout the legislative process relating to the legal and regulatory framework for central clearing of over-the-counter ("**OTC**") derivatives pursuant to Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivative transactions, central counterparties and trade repositories ("**EMIR**"), MFA has sought to provide input on matters central to the successful implementation of the key requirements under EMIR. MFA strongly supports efforts to promote central clearing of OTC derivatives and to reduce systemic risk. MFA therefore wishes to reinforce and further explain its request that ESMA require STP in the Final RTS in order to reduce counterparty credit risk and to improve the efficiency of OTC derivatives markets. In this spirit, MFA is providing accompanying comments on the Consultation Paper's draft RTS in the hope that our comments will assist ESMA in finalising RTS ("**Final RTS**") that will expressly mandate STP. In particular, MFA believes that STP is a predicate to the fulfilment of a number of key EMIR

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<sup>1</sup> Managed Funds Association ("**MFA**") represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent and fair capital markets. MFA, based in Washington, DC, is an advocacy, education and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, North and South America, and all other regions where MFA members are market participants.

<sup>2</sup> Available at: <http://www.esma.europa.eu/system/files/2012-379.pdf>.

objectives, including open market access, standardization and efficiency of operational market processes, and reduction of concentration and interconnectedness.

## **I. STP Is Called For and Essential Under the Final RTS EMIR**

MFA is concerned that, absent STP, client clearing arrangements, whether direct or indirect, could impose barriers on clients' ability to access clearing and competitive execution. In particular, it is important that such arrangements do not expose clients to the credit risk of their executing counterparty, which would undermine the risk reduction purpose of clearing. To address this concern, MFA has advocated consistently and strongly for straight-through-processing of transactions to clearing.<sup>3</sup> Straight-through-processing of derivatives transactions ensures that parties to derivative transaction are informed in real-time (or as close to real-time as possible) whether the transaction has been accepted for clearing. Once the transaction is accepted for clearing, the parties' counterparty risk exposure is to the central counterparty ("CCP") rather than the other market participant.

Article 11 of EMIR sets forth requirements related to mitigating risks of each non-cleared transaction.<sup>4</sup> Consistent with the risk mitigation elements of EMIR, the Final RTS should mandate the compression or effective elimination of the time between execution and confirmation of clearing acceptance, as is the norm in other cleared derivatives markets, including futures, equity options, and energy derivatives.<sup>5</sup> The Final RTS should require STP for processing and clearing derivatives transactions regardless of the execution method used by the parties and whether or not the transaction is subject to the EMIR clearing obligation.

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<sup>3</sup> See e.g., MFA's comment letter to ESMA on its Discussion Paper on "Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories", dated March 19, 2012, available at: [https://www.managedfunds.org/wp-content/uploads/2012/03/MFA.Response.ESMA\\_.EMIR\\_.Discussion.Paper\\_FinalLetter\\_03-19-2012.pdf](https://www.managedfunds.org/wp-content/uploads/2012/03/MFA.Response.ESMA_.EMIR_.Discussion.Paper_FinalLetter_03-19-2012.pdf) ("MFA Discussion Paper Letter"); MFA's Updated Response on Proposed Regulation on OTC Derivatives, Central Counterparties and Trade Repositories, dated January 19, 2012, available at: [https://www.managedfunds.org/wp-content/uploads/2012/01/Final\\_MFA\\_Updated\\_WhitePaper\\_on\\_EMIR.pdf](https://www.managedfunds.org/wp-content/uploads/2012/01/Final_MFA_Updated_WhitePaper_on_EMIR.pdf); MFA's comment letter to the CFTC on its proposed rulemakings on "Customer Clearing Documentation and Timing of Acceptance for Clearing" and "Clearing Member Risk Management", dated September 30, 2011, available at: [http://www.managedfunds.org/wp-content/uploads/2011/10/CFTC\\_Customer.Clearing.Documentation.and\\_.Timing.of\\_.Acceptance.for\\_.Clearing\\_Clearing.Member.Risk\\_.Management\\_FinalMFALetter.pdf](http://www.managedfunds.org/wp-content/uploads/2011/10/CFTC_Customer.Clearing.Documentation.and_.Timing.of_.Acceptance.for_.Clearing_Clearing.Member.Risk_.Management_FinalMFALetter.pdf); and MFA's comment letter to the CFTC on its proposed rules on "Requirements for Processing, Clearing, and Transfer of Customer Positions", dated April 11, 2011, available at: <http://www.managedfunds.org/wp-content/uploads/2011/06/4.11.11-CFTC-Customer-Positions-Rules-Final-MFA-Letter.pdf>.

<sup>4</sup> See Article 11(1) of EMIR, which provides, for example, that financial and non-financial counterparties ensure that they have appropriate procedures and arrangements in place to measure, monitor and mitigate operational risk and counterparty credit risk, including *at least*, the timely confirmation of contract terms and formalised processes to reconcile portfolios. Please also refer to Section II of this letter regarding the legal justification and authorised scope of regulatory technical standards ESMA may draft pursuant to Article 11 of EMIR, as per MFA's legal analysis.

<sup>5</sup> CCPs and clearing members are able and prepared to offer STP for standardised OTC derivatives, such as interest swaps and credit default swaps, and already have in place the technology required for STP. For example, in December 2011, CME cleared transactions in interest rate swaps of USD 4.1 billion in value and each transaction executed on an electronic trading platform was cleared in under two seconds.

Straight-through-processing benefits all market participants, especially smaller market participants and alternative liquidity providers that could otherwise encounter barriers to entry, in that it: (i) gives market participants certainty of clearing immediately following execution, which in turn, allows them to hedge more efficiently and effectively manage risk; (ii) is an important factor in encouraging the implementation of broad, mandatory clearing; (iii) is essential to electronic trading, particularly central limit order book trading, as it is not possible to enter into an electronic transaction on an anonymous basis without both the immediate confirmation of the execution of the transaction and its acceptance for clearing; and (iv) promotes accessible, competitive markets and access to best execution by ensuring parties to a cleared transaction have immediate confirmation that they will face the relevant CCP, thus eliminating the need to negotiate individual credit arrangements with each of their counterparties, as is required in bilateral derivatives markets.

MFA believes that if a client faces any delay in a CCP's acceptance of any transaction for clearing, it will result in the client trading with fewer counterparties, and that this will, by extension, increase concentration in the market, since it is typically the largest dealers that pose lower long-term counterparty credit risk and with whom clients are more likely to have in place bilateral master agreements. CCPs have a strong interest in ensuring the solvency of clearing members, and thus, straight-through-processing can broaden the number of suitable counterparties available and increase competition among them. Therefore, we feel strongly that failure to include a positive mandate for straight-through-processing timeframes undermines the fundamental policy goals of clearing by impeding optimal risk management, competitive liquidity and open access to the market.

Given the benefits of straight-through-processing, MFA respectfully requests that ESMA ensure the same real-time processing timeframe for all transactions submitted for clearing, regardless of the execution method used or whether or not the transaction is subject to mandatory clearing. In addition, to facilitate international harmonization of regulations and to ensure full realization of the benefits of client clearing, we believe that ESMA should draft technical standards on client clearing models, whether direct or indirect, that support straight-through-processing.<sup>6</sup> The regulatory obligation must apply not only to CCPs, but also to the clearing members, requiring them to confirm their guarantee of their clients' transactions either pre-execution, through binding pre-execution guarantees, or immediately post execution, through fully automated transaction acceptance workflows that provide the CCP immediate certainty that the transaction is guaranteed by the clearing member. Even if the CCPs have straight-through-processing upon receipt of the matched transaction, a delay in clearing member acceptance can interpose a window of delay that creates bilateral counterparty credit risk.

Moreover, in the U.S., the Commodity Futures Trading Commission ("CFTC") has demonstrated its robust support for straight-through-processing by issuing final rules that: (i) minimise or effectively eliminate the time between transaction execution and acceptance into clearing; and (ii) mandate straight-through-processing for all transactions regardless of the mode

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<sup>6</sup> See CFTC Final Clearing Documentation Rules at 21285, where the CFTC noted that prudent risk management dictates that once a transaction has been submitted to a clearing member or a CCP, the clearing member or CCP must accept or reject it as quickly as possible.

of execution, including both those executed on a designated contract market or swap execution facility as well as those executed outside an execution platform and submitted for clearing (*e.g.*, executed by voice).<sup>7</sup>

In support of our request to ESMA to include the straight-through-processing requirement in the Final RTS, we provide the following materials annexed to this letter:

- (i) an overview of the concept of straight-through-processing in the OTC derivatives markets;
- (ii) explanatory notes regarding: (A) the timeframe for clearing transactions; (B) the elimination of documentation burdens to clearing access through straight-through-processing; and (C) straight-through-processing of post-execution allocations;
- (iii) qualitative cost-benefit discussion of the straight-through-processing requirement;
- (iv) an extract of the CFTC rules mandating straight-through-processing for reference; and
- (v) MFA proposed provisions for regulatory technical standards mandating straight-through-processing.

## II. Legal Justification for Requiring STP in EMIR Final RTS

A. Analytical Overview. MFA strongly believes that ESMA has the necessary legal mandate under Article 11(14)(a) of EMIR to include a provision in the Final RTS requiring STP. ESMA's legal mandate can be identified on the face of Article 11(14)(a), and by adopting the correct interpretation of Article 11(14)(a) under the law of the European Union ("EU"), that is, by interpreting Article 11(14)(a) in light of the purpose and rationale of the objectives of EMIR, including the objective of minimising counterparty credit risk.

As acknowledged by the members of the ESMA Task Forces<sup>8</sup> during the ESMA hearing in Paris on July 12, 2012, STP is broadly acknowledged to mitigate counterparty credit risk and to improve the transparency and efficiency of derivative transactions. Further, in light of the

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<sup>7</sup> See CFTC Final Rules on "Customer Clearing Documentation, Timing of Acceptance for Clearing, and Clearing Member Risk Management", 77 Fed. Reg. 21307 (April 9, 2012) ("**CFTC Final Clearing Documentation Rules**"), available at: <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-7477a.pdf>, which require the acceptance or rejection of a transaction "*as quickly as technologically practicable if fully automated systems were used*". For ESMA's convenience, we provide a copy of the CFTC Final Clearing Documentation Rules in Annex 4 of this letter.

<sup>8</sup> ESMA's Post-Trading Standing Committee set up three task forces to develop the relevant draft technical standards that will be required under EMIR: the OTC Derivatives Task Force; the CCP Requirements Task Force; and the Trade Repositories Task Force.

other material benefits derived from STP, as outlined in Section I above, MFA respectfully requests that ESMA include in the Final RTS a requirement that all derivatives transactions that are submitted for central clearing, regardless of the execution method used, and whether or not the transaction is subject to the mandatory clearing obligation, be processed subject to STP.

As discussed below, ESMA has the legal authority to require STP under the Final RTS drafted under Article 11(14)(a) of EMIR. Such a requirement would support the objectives of EMIR, further the intended outcomes of EMIR and, by aligning the EU derivatives clearing regime with the U.S. regime for the clearing of derivatives transactions<sup>9</sup>, be consistent with the aim of integrated global regulatory reform of derivatives trading to achieve, as most recently stated by the Financial Stability Board (“FSB”), *“timely, full and globally consistent implementation of reforms are necessary in order to restore confidence and trust in the financial system and preserve the advantages of an open and globally integrated financial system.”*<sup>10</sup>

**B. Legal Basis for and Scope of Regulatory Technical Standards.** The Treaty of the Functioning of the European Union (“TFEU”)<sup>11</sup> allows the EU legislators to delegate to the European Commission (“EC”) *“the power to adopt non-legislative acts of general application to supplement or amend certain non-essential elements of a legislative act.”* Such non-legislative acts, known as delegated acts, include the RTS which the current ESMA consultation concerns. Further, the EU Regulation establishing ESMA<sup>12</sup> provides that ESMA shall develop and submit draft regulatory technical standards in relation to EMIR and other financial legislation to the EC for endorsement.

As recognised by the EC,<sup>13</sup> the scope of the types of acts constituting delegated acts is broad: *“the very wide range of measures that might be envisaged in a given situation precludes any attempt at classification.”*<sup>14</sup> Specifically, the EC believes that by using the word *“amend”* the authors of TFEU wanted to cover cases where the EC wishes to amend the text of one or more articles in a Regulation or a Directive. A delegated act would *“supplement”* a Regulation

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<sup>9</sup> See CFTC Final Rules on “Customer Clearing Documentation, Timing of Acceptance for Clearing, and Clearing Member Risk Management”, 77 Fed. Reg. 21307 (April 9, 2012), available at: <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-7477a.pdf>.

<sup>10</sup> Financial Stability Board reports to G20 Leaders on financial regulatory reform progress, 19 June 2012 (Ref no.: 38/2011).

<sup>11</sup> See Article 290 of TFEU, OJ C 306, Dec. 17, 2007.

<sup>12</sup> See Article 10 of Regulation (EU) No 1095/2010 of 24 November 2010 establishing a European Supervisory Authority (ESMA) amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC (“**ESMA Regulation**”), available at: [http://www.esma.europa.eu/system/files/Reg\\_716\\_2010\\_ESMA.pdf](http://www.esma.europa.eu/system/files/Reg_716_2010_ESMA.pdf).

<sup>13</sup> See Communication on the Implementation of Article 290 of TFEU, Dec. 9, 2009 COM(2009) 673 final (“**Communication**”), available at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2009:0673:FIN:EN:PDF>.

<sup>14</sup> See Section 2.3 of the Communication.

or a Directive where the act “specifically adds new non-essential rules which change the framework of the legislative act, leaving a margin of discretion to the EC.”<sup>15</sup>

Therefore, the intrinsic function of delegated acts, including the RTS, is to amend or supplement a legislative act of the EU, including a Regulation, such as EMIR. Thus, it is not necessary that a Regulation should make express provision for a specific requirement to be included within a regulatory technical standard.<sup>16</sup> As the EC further confirms, measures intended only to give effect to the existing rules of a Regulation or a Directive do not constitute delegated acts.<sup>17</sup> As has been noted by many commentators, the EC enjoys wide discretion under TFEU in the adoption of delegated acts, with minimal constraints.<sup>18</sup>

### C. Specific Legislative Mandate for STP

**Article 11(14)(a) EMIR.** Article 11 EMIR sets forth requirements related to mitigating risks of each non-cleared transaction. MFA considers that Article 11 EMIR provides the legislative mandate for ESMA to draft, and for the EC to endorse, Final RTS requiring STP. Specifically, Article 11(14)(a) EMIR requires ESMA to draft RTS specifying procedures and arrangements to, *inter alia*, mitigate operational and counterparty credit risk. Given the known risk mitigation benefits of STP, this requirement is clearly capable of embracing STP.

More specifically, Article 11(1) EMIR requires that “financial and non-financial counterparties that enter into an OTC derivative contract not cleared by a CCP shall ensure, exercising due diligence, that appropriate procedures and arrangements are in place to measure, monitor and mitigate operational risk and counterparty credit risk, including at least:

(a) the timely confirmation, where available, by electronic means, of the terms of the relevant OTC derivative contract; and

(b) formalised processes which are robust, resilient and auditable in order to reconcile portfolios, to manage the associated risk and to identify disputes between parties early and resolve them, and to monitor the value of outstanding contracts.”

Article 11(14) EMIR then provides that: “In order to ensure consistent application of this Article, ESMA shall draft regulatory technical standards specifying: (a) the procedures and arrangements referred to in paragraph 1.”

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<sup>15</sup> See *id.*

<sup>16</sup> Indeed, MFA notes, for example, that portfolio compression has not been expressly required under EMIR and yet appears in a draft RTS.

<sup>17</sup> See Section 2.2 of the Communication.

<sup>18</sup> Articles 11-14 of the ESMA Regulation provide only limited constraints on the EC’s discretion.



Based on a careful reading of Article 11(1), we believe its scope extends to “counterparties that enter into an OTC derivative contract not cleared by a CCP.” Upon the entry by the parties to a transaction concerning an OTC derivative contract, necessarily, all OTC derivatives contracts are not cleared until such time as the parties have received confirmation from a CCP that the transaction has been accepted for clearing. This non-cleared status of a derivative contract until it is accepted for clearing persists regardless of whether a CCP currently exists which can clear such a contract after the counterparties have entered into the contract. Indeed, given the nascent stage of CCP development in the EU, it will be several years before CCPs are able, and authorised under EMIR, to clear most classes of derivatives contracts. In the meantime it is critical that STP is required so that “at least...timely confirmation” and other risk management processes take place in relation to transactions that will be cleared.

**Consistency with the Teleological Interpretation of EU Law.** Interpreting Article 11(14)(a) to include an STP requirement is entirely consistent with the teleological approach used by the Court of Justice of the European Union (“CJEU”), the highest court in the EU, when interpreting EU law.<sup>19</sup> Pursuant to this approach, specific provisions in EU Regulations and other EU legislative acts are interpreted based upon the purpose or object of the legislation as a whole, taking into account also the *travaux préparatoires*<sup>20</sup> and other related documents. There are numerous CJEU cases where the purpose and spirit of an EU legislative act dictated the judge’s interpretation of the relevant Article. In the leading case of *Continental Cans*<sup>21</sup> the CJEU held that “in order to answer this question<sup>22</sup>... one has to go back to the spirit, general scheme and wording of Article [82], as well as to the system and objectives of the Treaty” when interpreting EU legislation.<sup>23</sup>

In the financial services context, the CJEU has held that it is correct to interpret a specific legal provision in an EU Regulation in a manner that is consistent with the underlying purposes

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<sup>19</sup> It is also used by the English courts when interpreting EU law, in addition to EU Member States embracing the civil system.

<sup>20</sup> Collective name for all the documentation drawn up during the preparation of an EU legislative act.

<sup>21</sup> See Judgment of the Court of February 21, 1973, Europeuballage Corporation and Continental Cans Inc. v Commission of the European Communities (Case C-6/72) available at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:61972J0006:EN:HTML>.

<sup>22</sup> The question under consideration in the case was whether Article 82 EC applies to general changes in the structure of an undertaking.

<sup>23</sup> See also Judgment of the Court Commission v. Council ERTA (Case 22/70) where despite the apparently exhaustive wording of the Article in question regarding several categories of measures, the CJEU held that the aim of the EU law in question was to subject to judicial review all measures taken by the institutions designed to have legal effect. Accordingly, the CJEU confirmed that: “It would be inconsistent with this objective to interpret the conditions under which the action is admissible so restrictively as to limit the availability of this procedure merely to the categories of measures referred to by Article 249.”

of that EU Regulation. In *Seagon v Deko*<sup>24</sup> the CJEU held that, despite the limited scope of the express provisions in Article 3(1) of the Insolvency Regulation, it was necessary and appropriate to interpret Article 3(1) to mean that other, analogous rights were derived under the Article. On a reference to the CJEU in relation to the correct interpretation of Article 3(1), the CJEU held that Article 3(1) had to be interpreted as meaning that the court of a Member State before which insolvency proceedings were pending had jurisdiction to set aside a transaction against an addressee of avoidance having its registered office in another Member State. Article 3(1) had to be interpreted as meaning that it also contributed international jurisdiction on the Member State within the territory of which the insolvency proceedings were opened in order to hear and determine actions which derived directly from those insolvency proceedings and which were closely connected to them, despite the Article only specifying that it was the jurisdiction of the debtor's centre of main interests that had jurisdiction to open insolvency proceedings. Although Article 3(1) only specified that the EU member state of a debtor's centre of main interests had jurisdiction to deal with the insolvency proceedings, the CJEU held that Article 3(1) also contributed international jurisdiction on an EU member state within the territory of which the insolvency proceedings were opened in order to hear and determine actions which derived directly from those insolvency proceedings and which were closely connected to them. The CJEU noted that such interpretation was consistent with the objective of improving the effectiveness and efficiency of insolvency proceedings having cross-border effects, as referred to in the Recitals to the Insolvency Regulation.<sup>25</sup>

***An STP Requirement is Consistent with, and Furthers the Objectives of, EMIR.*** EMIR establishes clearing as the central means to mitigate counterparty risk and support transparency in the OTC derivatives markets. MFA asserts that STP is consistent with, and is necessary to enable, these aims to be fulfilled. Indeed, in addition to the legal mandate provided in Article 11(14)(a), various other provisions support an STP requirement.

For example, recital 4 states that EMIR “*lays down conditions for mitigating those [financial stability, counterparty credit] risks and improving the transparency of derivative contracts*”. Recital 9 emphasises the “*need to substantially improve the mitigation of counterparty credit risk and... to improve transparency, efficiency and integrity of derivative transactions*” which can only be substantially achieved with STP. Recital 24 states that “*to mitigate counterparty risk, market participants who are subject to the clearing obligation should have risk-management procedures that require the timely, accurate and appropriately segregated exchange of collateral*”. STP is necessary to ensure that CCPs are able to assess their collateral exposures and requirements in real-time. The ability to facilitate risk management in real-time enables CCPs to protect both themselves and other market participants.

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<sup>24</sup> See Judgment of the Court (First Chamber), February 12, 2009 Christopher Seagon v Deko Marty Belgium NV (Case C-339/107), in relation to the correct interpretation of Article 3(1) of the Council Regulation (EC) 1346/2000 (“**Insolvency Regulation**”).

<sup>25</sup> See Recital 2 and Recital 8 of the Insolvency Regulation. The CJEU noted that Recital 4 also supported this interpretation as it highlighted the necessity for the proper functioning of the internal market to avoid incentives for parties to transfer assets or judicial proceedings from one EU member state to another, seeking to obtain a more favourable legal position.



Furthermore, Recital 34 and Recital 35 of EMIR state that CCPs must provide open access, meaning that CCPs must accept transactions regardless as to where and how they are executed, that liquidity must not be fragmented and that competitive distortions are unacceptable. MFA notes that in the absence of a requirement for STP, it will be difficult to achieve these objectives. Article 7(1) of EMIR requires non-discriminatory and transparent access to CCPs. We reiterate that, without a requirement that CCPs and clearing members provide STP, access to clearing is necessarily limited and discriminatory as parties will be required to enter into additional arrangements to gain access to clearing beyond a basic clearing agreement. Article 40 of EMIR requires CCPs to measure and assess their liquidity and credit exposures to each clearing member (and, where relevant, to another CCP with which it has concluded an interoperability arrangement) “*on a near to real-time basis*”, which necessitates STP, as does ensuring “*each participant in the cleared market [is] to similarly be able to understand their liquidity and credit exposure.*” Article 41 requires a CCP to collect intra-day margin to cover risks stemming from positions held in specific financial instruments and authorises ESMA to draft RTS to determine the minimum margin levels CCPs shall require. The above provisions, supported by Recitals 95 and 96 of EMIR, clearly indicate the overall scope of the authority of the EC, and thus ESMA by delegation to supervise and regulate the different aspects of the post-execution operation of the derivatives markets, and grants the EC (and ESMA, by delegation) a broad range of powers to take appropriate measures to ensure the consistent and effective application and development of regulations, standards and practices falling within the scope of EMIR.

***The Need for Harmonised Regulation of Global Markets: CFTC STP Rulemaking.*** As recognised by the G20 leaders, the FSB, the EC and various other supra-national (and national) authorities, OTC derivatives markets are global and require consistent cross-border regulation. In the absence of consistent regulation, risks of regulatory lacunae, practices of regulatory arbitrage and artificial market asymmetries will arise in the derivatives markets. Most recently the FSB stressed the continued importance of timely, full and consistent implementation of agreed reforms in order to restore confidence in the financial system and to preserve the advantages of an open and globally integrated financial system, adding that: “*recent experience demonstrates that when market participants and authorities lose confidence in the strength of financial institutions and markets in other countries, the retreat from an open and integrated system can occur rapidly.*”<sup>26</sup>

Given the significant number of OTC derivatives transactions between U.S. and EU counterparties and/or involving EU and U.S. underlyings and assets, the alignment of U.S. and EU rulemaking is critical for the effective regulation of derivatives markets. In the EMIR *travaux préparatoires* the EC positively acknowledged the similarities and consistencies with the equivalent Dodd-Frank provisions, indicating the persuasive authority of Dodd-Frank enactments.<sup>27</sup> Since then, on April 9 2012, the CFTC issued final rules that minimise or

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<sup>26</sup> Financial Stability Board reports to G20 Leaders on financial regulatory reform progress, 19 June 2012 (Ref no.: 38/2011).

<sup>27</sup> See, e.g., Proposal for a Regulation on OTC derivatives, central counterparties and trade repositories 2010/0250 (COD) September 15, 2010.

effectively eliminate the time between the execution of a transaction and its acceptance into clearing (requiring acceptance or rejection of a transaction "*as quickly as technologically possible if fully automated systems were used*"), and mandate STP for transactions executed on a designated contract market or swap execution facility as well as outside an execution platform and submitted for clearing.<sup>28</sup> MFA submits that, in light of the global nature of the derivatives markets and the volume of cross-border activity between market participants in the EU and the U.S., the approach taken in the U.S. to expressly require STP would be usefully replicated in the EU in order to ensure an effective and consistent regulation of the global derivatives markets.

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MFA thanks ESMA for the opportunity to provide accompanying comments regarding straight-through-processing in relation to the proposals in the Consultation Paper and we would welcome the opportunity to discuss our views further in greater detail. Please do not hesitate to contact Laura Harper, Carlotta King, or the undersigned at +1 (202) 730-2600 with any questions ESMA or its staff might have regarding this letter.

Respectfully submitted,

Stuart J. Kaswell

Stuart J. Kaswell  
Executive Vice President & Managing  
Director, General Counsel

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<sup>28</sup> See *id.* A copy of the CFTC Final Clearing Documentation Rules is also provided in Annex 5 for convenience.

## **Annex 1**

### **Overview – Straight-Through-Processing is Called For and Essential under EMIR**

# Real Time Acceptance is Critical to Achieving EMIR Policy Objectives

- » Real time acceptance is central to achieving the core OTC derivatives market reform goals, as laid down in EMIR, of mitigating systemic risk, reducing counterparty credit risk, and fostering transparency and competition.
- » Confirming or rejecting trades for clearing in real time (“**real time acceptance**”), rather than hours or days after execution, is vital to genuinely reducing systemic risk and counterparty credit risk, as real time acceptance:
  - » Eliminates bilateral counterparty credit risk and reduces interconnectedness
  - » Improves competition and decreases market concentration
  - » Eliminates failed trades
  - » Lays the foundation for electronic trading and heightened transparency
- » We believe that EMIR calls for L2 standards to establish binding technical requirements for real time acceptance.
- » Implementing a real time acceptance standard will also help realize other important EU policy objectives in the post-trading sphere, including ensuring settlement finality, preventing liquidity fragmentation, and reducing operational risk.

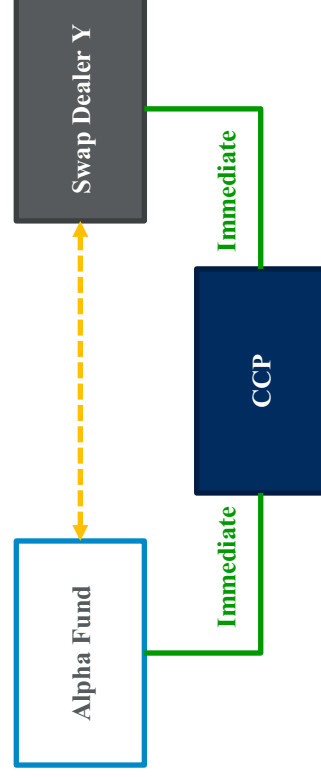
# Real Time Acceptance

## Comparison of timing of acceptance paradigms

### Real time acceptance / STP

*Trade executed and submitted for clearing immediately*

*Trade conditional on acceptance for clearing*

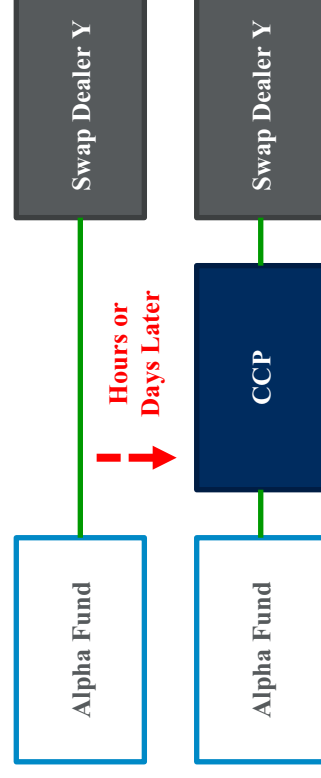


- » Counterparty credit risk completely eliminated, since counterparties immediately face the CCP
- » No prospect for failed trades or breakage
- » Technological efficiency (Straight-Through-Processing – STP) replaces documentary burdens, with only clearing agreements needed
- » Freedom to execute with any counterparty
- » Indispensable foundation for electronic execution on central limit order books (“CLOBs”)
- » Encourages competition and new entrants, thereby enhancing liquidity and narrowing bid-ask spreads
- » Enhances reporting – market prices are reported in real time and all prices are for completed trades

### Delayed acceptance / Manual

*Trade executed and submitted for clearing hours or days later*

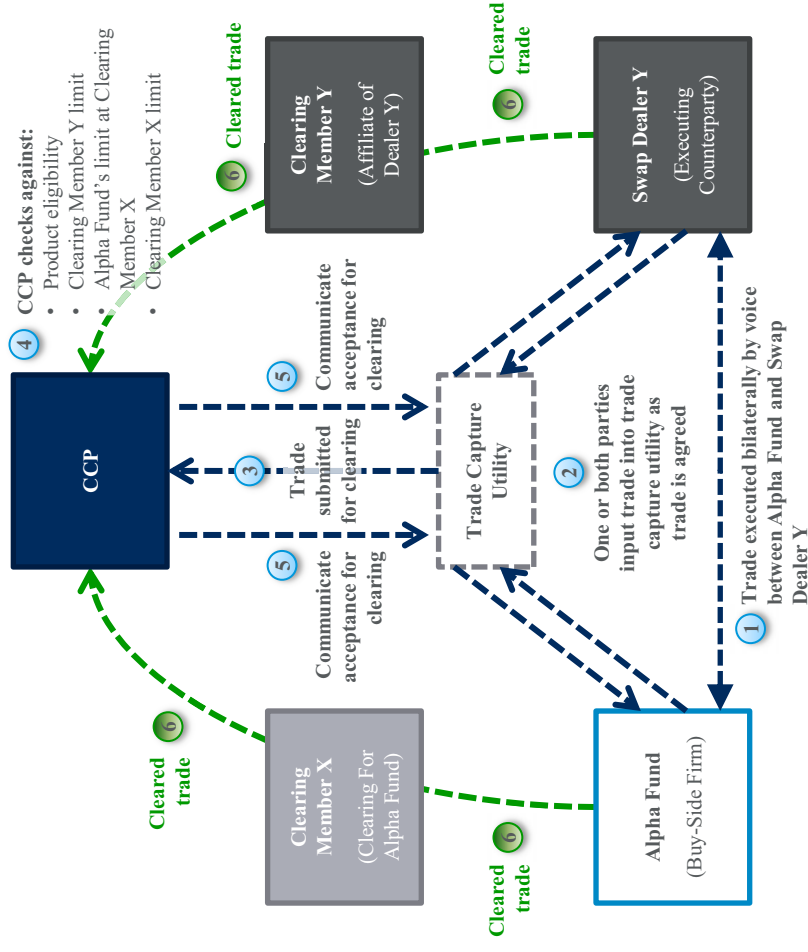
*Trade exists as bilateral (i.e. uncleared) until accepted for clearing*



- » Window of counterparty credit risk remains, which requires credit intermediation, and drives concentration of trading to too-big-to-fail counterparties
- » ISDA-like execution agreements needed with every counterparty, on top of clearing agreements
- » Restricted choice of execution counterparties – fragments buy-side access to liquidity
- » Limits competition and perpetuates barriers to entry, thereby restricting liquidity and preventing bid-ask spread compression
- » Inhibits trading from migrating to CLOBs
- » Risk of fail and breakage damages if trade is not accepted



# Workflow



- » CCPs, 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 CCP prior to acceptance (see ④), and key to this validation is the customer limit check. There are several 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 CCP*: Clearing member authorizes CCP to screen trades on its behalf and to accept or reject according to criteria set by the clearing member
  - » *Post-trade, at clearing member level*: Messaging from the CCP to the clearing member for each trade requesting acceptance or rejection, followed by reply message
- » Each approach can be done in real time.

# Real Time Acceptance

## An essential element of safe OTC derivatives markets

- » Establishing L2 requirements for real time acceptance of OTC derivatives in EU markets will:
  - » Fully eliminate counterparty credit risk concerns – clearing allows participants in cleared markets to **transact without barriers** with all other eligible market participants, but **only** if there is real time acceptance
  - » Provide clearing and trading certainty for market participants – 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)
  - » Create an **open and level competitive playing field** for execution, improve pricing, and maximize access to liquidity for all participants, large and small, even in periods of stress
  - » Ensure **international consistency** – The CFTC has finalized rules requiring real time acceptance which go into effect on October 1, 2012. Industry participants have made substantial progress in advancing a framework for CCPs, clearing members, and trading venues to implement real time acceptance market-wide.
- » **The alternative to real time acceptance** – i.e. maintaining a window of counterparty credit risk between execution and clearing that then would warrant credit intermediation – **undercuts clearing's positive impacts.**
- » **Without real time acceptance**, EMIR's core objective of establishing a clearing foundation for electronic execution and transparency **will be critically weakened.**

# Real Time Acceptance

## L2 standards on real time acceptance are mandated by EMIR

- » EMIR Article 11 mandates ESMA to establish standards to mitigate the risk of each non-cleared trade. Each trade, when executed, is non-cleared until formally accepted for clearing by the CCP.
- » The standard needed to eliminate the risks of non-cleared executions prior to clearing is to require the compression or effective elimination of the time between execution and confirmation of clearing acceptance, as is the norm in other established cleared derivatives markets.
- » Accordingly, the real time acceptance standard should be required under Article 11 as part of EMIR's Level II Technical Standards.
- » A range of further EMIR provisions establish ESMA's authority to set out technical standards for post-execution processing.
- » Further, real time acceptance is a predicate to the fulfilment of material specific EMIR provisions, including those stipulating open access, prevention of liquidity fragmentation, standardization and efficiency of operational processes, and reduction of market concentration and interconnectedness.

# Real Time Acceptance

## Essential for meeting EMIR reform goals

### Reducing Counterparty Risk

Real time acceptance is the indispensable predicate to material mitigation of counterparty credit risk, both for individual participants as well as on a market-wide basis. Any window of counterparty credit risk between execution and clearing, multiplied by all the trades outstanding, leaves significant uncleared exposures, open interconnected bilateral risk, and uncertainty in a volatile environment. These factors constrict liquidity in periods of volatility, undermining participants' ability to risk manage when it matters most.

### Transparency

Real time acceptance is essential to genuine electronic trading. Without it, limit order book trading is blocked, preventing effective pre-trade transparency. Further, without real time acceptance, customers are denied free choice of counterparty.

### Reduce Concentration Risk

The lack of real time acceptance leads to continuation of bilateral credit intermediation underneath clearing to cover the window between execution and clearing. This in turn fragments liquidity, limits access to competitive execution, and ties clearing to execution. This also concentrates dealing in a few too-big-to-fail counterparties, and is thus anti-competitive from the perspective of the customer, as well as from the perspective of trading venues that will offer open, competitive execution and seek equal access to CCPs.

### International Harmonization

The CFTC has finalized rules requiring real time acceptance which go into effect on October 1, 2012. Industry participants have made substantial progress in advancing a framework for CCPs, clearing members, and trading venues to implement real time acceptance. This framework is fully suitable for European OTC derivatives markets.

# Annexes

Annex I – U.S. CFTC approach

Annex II – Industry Progress



# Annex I – US CFTC Approach

## CFTC Final Rule: Description of performance standard

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. 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.

*“Action in a matter of milliseconds or seconds or, at most, a few minutes, not hours or days”*

# Annex I – US CFTC Approach

## CFTC Final Rule: Technical excerpts

### FCMs

#### § 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;

### Swap Dealers and MSPs

#### § 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;

### DCOs

#### Subpart B—Compliance With Core Principles

9. Amend § 39.12 by:

a. Redesignating paragraph (b)(7)(v) as paragraph (b)(8); and

b. Revising § 39.12(b)(7) to read as follows:

(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.

*All effective October 1, 2012*

# Annex II – Industry Progress

## EU should leverage industry progress on real time acceptance

- » 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 members are prepared to support real time acceptance.
- » In December 2011, \$4.1 Billion in interest swap trades executed on a production electronic trading platform were cleared at CME each in under 2 seconds; the trades were both dealer-to-dealer and customer-to-dealer.
- » A joint FIA-ISDA working group of international dealers, clearing members, buy-side participants, CCPs and SEFs has worked for over a year to establish guidelines for real time acceptance, and to support industry compliance with the CFTC real time acceptance requirements:
  - » The working group has defined a set of principles, to help standardize real time acceptance workflows across a range of execution approaches (CLOB, RFQ, voice);
  - » The working group in the process of establishing an industry-standard messaging protocol for real time acceptance flows, thereby providing for consistent communication flows and promoting open access.
- » The requirement for real time acceptance 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; eliminating execution agreements makes cleared OTC derivatives markets consistent with other established cleared derivatives markets, and removes a crucial barrier to access to clearing and to competitive pricing for buy-side participants.

## Annex 2

### Explanatory Notes regarding the Requirement for Straight-Through-Processing under the Final RTS

#### A. Timeframe for Clearing Transactions

MFA urges ESMA to adopt straight-through-processing (“STP” or, as used interchangeably herein, “**real-time clearing acceptance**”) as the standard for effectively eliminating counterparty credit risk between the point an OTC derivatives transaction is executed and the point at which the transaction is formally accepted by a CCP for clearing. To do this, the Final RTS should require STP for processing and clearing transactions regardless of the execution method used and whether or not the transaction in the derivative contract is subject to mandatory clearing. Further, the timeframes for processing and acceptance should be required to be the same for transactions regardless of participant type, in other words, a dealer to client transaction or a client to client transaction should clear as quickly as a dealer to dealer transaction. MFA strongly supports STP because (i) it gives market participants certainty of execution thereby allowing them to hedge more efficiently and maintain balanced risk management;<sup>29</sup> (ii) it is critical to support the implementation of broad mandated clearing; (iii) it is essential to electronic trading, particularly in support of limit order book trading and so is a critical step in fulfilling EMIR’s transparency requirements; and (iv) it is essential in promoting open, competitive markets and access to best execution, as it allows parties to a cleared transaction immediate certainty that they face the clearinghouse, eliminating the need for individually negotiated credit agreements with each counterparty they transact with, as is required in the bilateral market.

In this context, we respectfully request that ESMA impose the same real-time clearing acceptance timeframe for all transactions submitted for clearing, regardless of the execution method used or whether or not the transaction is subject to mandatory clearing. We are concerned that if a client faces a delay in the clearing acceptance for any derivatives transaction, even a delay to the end of the day, it will result in the client trading with fewer counterparties, typically the largest dealers, that pose lower long-term counterparty credit risk or with which clients already have a bilateral International Swaps and Derivatives Association, Inc. (“ISDA”) master agreement in place. In contrast, real-time clearing acceptance benefits the market because if a client has clearing certainty and there is no risk of long-term bilateral counterparty credit risk exposure, the client will be more willing to transact with any competitive, eligible counterparty, without the need for extensive documentation and credit intermediation or other credit arrangements. Indeed, without real-time clearing acceptance, access for alternative liquidity providers to the market is impaired, and it will be impossible for an open, all-to-all market to evolve. Clearing with embedded delays in the process from transaction execution to

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<sup>29</sup> Real-time acceptance for clearing is essential to risk management because when a client executes a transaction, it may be part of a larger strategy involving linked or offsetting transactions. The client must know with certainty that its transaction will clear since it will immediately enter into related transactions in reliance on the execution of the cleared transaction.

clearing acceptance undermines the fundamental policy goals of clearing by limiting optimal risk management, competitive liquidity and open access to best execution.

We recommend that ESMA make it clear that as long as a CCP receives a matched transaction submission according to open and reasonable messaging requirements, the CCP would be required to process each transaction for acceptance or rejection for clearing in real-time. For a CCP, there is no practical difference between processing a transaction that is subject to mandatory clearing and processing a transaction that the parties clear voluntarily; or between processing a transaction executed on a trading venue and processing a transaction executed bilaterally using a voice-based system (or for processing particular types of transactions, such as block transactions<sup>30</sup>). Delay in processing derivatives that are not subject to the clearing mandate will deter central clearing of such derivatives generally, thus slowing the progressive expansion of the centrally cleared derivatives products and volumes of centrally cleared derivatives. Thus, we believe there should be no distinction in treatment between processing of derivatives transactions that are subject to mandatory clearing and those that are not.

### **B. Elimination of Documentation Burdens to Clearing Access through Straight-Through-Processing**

MFA believes ESMA should prohibit CCPs and clearing members from imposing any arrangement, including any documentation frameworks, between transacting counterparties as a precondition to access to clearing in the Final RTS. As in other long-established cleared derivatives markets, the only documentation that should be necessary in order for a party to clear a transaction in a derivative contract is that party's arrangement with its clearing member and the rules of the clearinghouse.

Further, the Final RTS should prohibit clearing members from imposing execution limits or other forms of restrictions that are anti-competitive or otherwise limit a client's ability to achieve best execution in the relevant market, including without limitation, any imposition of "guaranteed clearing" arrangements when less restrictive means are available to achieve certainty of clearing or recovery of breakage.<sup>31</sup> We believe that if parties execute a derivative transaction that is to be cleared (whether submission for clearing is voluntary<sup>32</sup> or mandatory), the derivative contract is binding at its execution subject to clearing, and if the CCP rejects it, there is no transaction binding contractual obligation (absent a fallback arrangement agreed between the transacting parties). A transaction in a cleared derivative contract, for example, a

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<sup>30</sup> We appreciate that certain investment managers may need to engage in a second stage process in order to manage allocations (*e.g.*, for bunched or aggregated transactions). For a CCP, we believe there should be no distinction regardless of whether parties are allocating portions of the transaction in accordance with separate agreements between an investment manager and its clearing member or clearing members as part of a separate allocation process.

<sup>31</sup> "Breakage" refers to losses incurred by a party when its counterparty's side of the transaction is rejected for clearing and the transaction is cancelled due to the fact that it engaged in hedging or related transactions in the expectation that the transaction would clear.

<sup>32</sup> In the case of voluntary submission, the parties would have the option to agree to a fallback of a bilateral contract, subject to relevant documentation.



transaction in a future, should require no ISDA or other bilateral agreement between the transacting parties for valid execution. If clearing of such a derivative contract is not mandatory, the parties could contract in advance to fallback to a bilateral derivative in the event the derivative is rejected for clearing, but such a fallback arrangement should be at the option of the parties and should not be a prerequisite to entering into a transaction in a centrally cleared derivative contract.

Delay in accepting a derivative contract for clearing increases the probability and potential quantum of breakage. A working group sponsored by Futures Industry Association (“FIA”) and ISDA in the United States in 2011 produced a form of optional agreement between executing counterparties intended to allocate liability for any such breakage (a “bilateral” agreement between executing counterparties). In addition, the agreement template contained optional annexes sought by some derivatives dealers that were intended not only to allocate liability for such breakage but also limit the risk that the at-fault party could then default on its contractual obligation to pay breakage (*e.g.*, by requiring that the other party’s clearing member “guarantee” that it would clear its clients transactions). The mechanics of such a “trilateral” guaranteed clearing arrangement required that there no longer be anonymity between a clearing member and its client’s trading counterparties. As a result, such arrangements would have allowed the clearing member to limit the range of its client’s counterparties and drive the client to execute with the trading desk affiliate of the clearing member, both of which would have an anti-competitive effect that undermines best execution. Real-time clearing acceptance essentially eliminates the need for these arrangements, and the CFTC determined through final rulemaking that such arrangements were unnecessary and potentially anti-competitive and therefore prohibited them. We also observe that such arrangements are not required or customarily used in other cleared markets (including other cleared derivatives markets). We therefore believe it would be appropriate for the Final RTS, consistent with the CFTC final rules, to:

- (1) prohibit a clearing member from requiring, as a precondition to executing a cleared derivative, documentation or other arrangements that undermine a participant’s access to competitive liquidity and best execution; and
- (2) prohibit a clearing member from imposing execution limits or other forms of restrictions that compromise anonymity between a client’s trading counterparties and its clearing member or are in any way anti-competitive or otherwise inhibit a client’s ability to achieve best execution in the relevant market (without limiting a clearing member’s right to impose and adjust overall position/credit limits on a client’s net open position with its clearing member).<sup>33</sup>

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<sup>33</sup> We note in this regard that the current Chicago Mercantile Exchange (“CME”) credit default swap (“CDS”) model, the CME and International Derivatives Clearing Group interest rate swap (“IRS”) model, as well as the ICE energy swaps model, all provide anonymity of transacting parties, consistent with the futures transaction flow model. ICE Clear Credit and LCH.Clearnet similarly have publicly announced they have or are building CDS and IRS transaction flows that provide real-time acceptance and support anonymity.

MFA also believes that real-time clearing acceptance and streamlined documentation procedures are essential to the development of transparency and electronic trading. To encourage this development, we respectfully suggest that ESMA should require CCPs to support real-time clearing acceptance of transactions executed on trading venues by mandating that CCPs have universally disciplined, real-time processes to take standard messages regarding matched transactions from such venues, and run the clearing acceptance process and deliver real-time messages immediately back to the trading venues that the CCP has accepted the transaction.

Real-time clearing acceptance also protects the anonymity of a client's executing counterparties because the clearing member faces only its client and the CCP once the transaction clears, and does not interact with its client's executing counterparties. Anonymity is vital to creating an open, efficient, level, competitive playing field in the derivatives market by prohibiting a clearing member from:

- (1) exerting influence on, or otherwise restricting, a client's choice of executing counterparties;
- (2) making biased or anticompetitive decisions with respect to the allocation, administration, or adjustment of its clients' execution sub-limits across executing counterparties;
- (3) sharing information with its affiliates that deal in derivatives about its clients' executing counterparties; or
- (4) inappropriately signaling to the market information about the client by using designation or other similar notices<sup>34</sup> to a client's executing counterparties to adjust such client's limit upward or downward.

We submit that the trilateral documentation arrangement is highly susceptible to such conflicts of interest in that it would shift execution either to a clearing member's affiliates that deal in derivatives or, due to the burden of having to negotiate extensive documentation and administer execution sub-limits, a limited number of the largest derivatives dealers. STP eliminates any basis for claiming a need for trilateral agreements or other credit intermediation under clearing, and thus eliminates any basis for compromising anonymity.

We wish to emphasize that a core goal of EMIR is to eliminate the risks of bilateral counterparty credit risk through clearing. When clearing is performed with STP, counterparty credit risk between bilateral executing parties is effectively eliminated, and with this the need for any form of execution documentation such as an ISDA agreement. For this reason all established cleared derivatives markets do not have execution documentation. Were such documentation required for cleared OTC derivatives, the process for clients to complete these agreements would represent a material hindrance to access, and would result in fragmentation of

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<sup>34</sup> A "designation notice" is a notice of credit sub-limits, or a change therein, as used in the prime brokerage context and market participants would use it in conjunction with the FIA-ISDA Cleared Derivatives Execution Agreement's trilateral annexes.

liquidity for clients and impede clients' access to competitive pricing. Instead, for cleared OTC derivatives, we believe the sole document required for clearing access should be the agreement a client enters into with its clearing member.

### **C. The Final RTS Mandating STP Will Support Post-Execution Allocations of Block Transactions to Multiple Funds**

Certain clients that act as investment managers, including members of MFA, regularly engage in a post-execution process to allocate a single "bunched" or "bundled" transaction among multiple funds. This allocation process enables fund managers to seize opportunities and secure the best price for their funds, and to manage situations where only a partial fill of an order is available. We understand, based on industry discussions, that from the CCP's perspective there is no practical difference in processing this type of transaction compared to other transactions. Therefore, a CCP and its participating clearing members should be able to comply with the STP requirement in circumstances where an investment manager is allocating, after execution, portions of a cleared transaction: (a) pursuant to a separate agreement with its clearing member or (b) to multiple clearing members as part of a separate allocation process. Thus, such transactions can be accepted for clearing immediately and clearing does not have to be delayed while the investment manager conducts the allocation process.

Arrangements between clearing members and investment managers who manage multiple funds are long established in other markets, such as the futures market, and provide the model for clearing certainty, followed by post-execution allocation, for cleared OTC derivatives.<sup>35</sup> These "standby" clearing arrangements are important to investment managers who allocate bunched transactions across multiple funds or accounts, since they allow the bunched transactions to be immediately accepted for clearing, ensure access to the widest range of counterparties and fulfill the investment manager's duty to secure best available execution on behalf of its client funds. Furthermore, a standby clearing arrangement that allows pre-execution clearing certainty of the bunched transaction is an essential condition for a multi-fund complex to access anonymous central limit order book markets. As noted, a central limit order book cannot function with a window of uncertainty between execution and clearing. Accordingly, without the standby arrangement, a multi-fund complex would not be able to execute bunched transactions in central limit order book markets, and instead would only be able to execute individual transactions for each of its accounts.

Finally, for investment managers who manage a large number of accounts, having to enter into execution documentation with each trading counterparty on behalf of each individual account would create a prohibitive documentary burden to their access to cleared derivatives markets. The standby clearing arrangement, which enables real-time clearing, eliminates any need for bilateral credit arrangements to cover the period between execution and allocation for

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<sup>35</sup> Upon execution, a clearing member serves as a "standby" clearer for the entirety of a portfolio manager's bunched transaction. The standby clearer effectively guarantees to the CCP that the bunched transaction will clear, thereby allowing the CCP to accept the transaction immediately for clearing. Then, as allocation instructions are provided by the client (typically within a two-hour window), the bunched transaction is divided up and cleared to the accounts of the individual funds. This solution functions equally well when all the accounts use the same clearing member or a range of clearing members.

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clearing to the individual fund accounts. Therefore, we believe that the STP requirement will enhance (rather than limit) the ability of investment managers to allocate bunched transactions across multiple funds or accounts.

### Annex 3

#### **Proposed Final RTS Mandating Straight-Through-Processing of OTC Derivatives Transactions for Clearing – Qualitative Cost-Benefit Discussion<sup>36</sup>**

The proposed Final RTS mandating STP is overwhelmingly justified from a cost-benefit analysis perspective. Its benefits are significant and multi-faceted. The combination of real-time acceptance for clearing, coupled with preventing trilateral execution agreements or other forms of credit intermediation under clearing from being imposed on the industry, will have the following benefits:

- Reduces systemic risk: Eliminating any window of counterparty credit risk between execution and clearing further reduces systemically risky interconnectedness in the derivatives markets.
- Promotes competition among clearing members: Decoupling the provision of execution and clearing services ensures that clearing members can compete on a standalone basis based on the robustness, quality, and pricing of their clearing services.
- Promotes competition among derivatives dealers: Removing barriers to entry for alternative liquidity providers enables smaller derivatives dealers to compete on more equal terms with the current limited universe of large derivatives dealers who presently control the vast majority of liquidity in the derivatives market.
- Increases market depth and liquidity: Ensuring that more derivatives dealers are able to compete for a client's execution business will increase the depth of the market. In addition, the emergence of an all-to-all-market and an environment that allows for new entrants to the market on the buy-side as well as the sell-side will enhance liquidity.
- Narrows bid-ask spreads: Increased competition, the entry of alternative liquidity providers, the development of an all-to-all market, and the emergence of electronic and/or anonymous execution will combine to narrow bid-ask spreads in the derivatives markets.
- Improves access to best execution: The ability to transact freely with any execution counterparty in the market, unfettered by unwarranted sub-limits on execution size, coupled with narrower bid-ask spreads, improves access to best execution. This applies equally to smaller participants as it does to larger participants, and applies, as noted above, in periods of market stress or volatility.
- Benefits real economy: Increased competition and better pricing in the derivatives

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<sup>36</sup> MFA has been unable to obtain access to the requisite data in support of this cost-benefit discussion.

markets directly benefits investors, including pension funds and endowments, on whose behalf institutional investors manage money. In addition, tighter pricing in the derivatives market and a wider variety of liquidity providers ensures that corporate end users can more economically and efficiently conduct their hedging and risk management activities.

Meanwhile, the cost of the proposed Final RTS mandating STP is incrementally minimal and has already been factored into the industry's investment thus far and its planning for operational compliance going forward. In fact, besides delivering the benefits enumerated above, the proposed Final RTS mandating STP will affirmatively save the industry money:

- Proposed Final RTS mandating STP save money: Eliminating trilateral execution agreements or the imposition of other forms of credit intermediation under clearing would actually save the industry substantial unnecessary legal costs that would arise across the industry if clients had to enter into execution agreements with not only each of their execution counterparties, but also an exponentially greater number of trilateral annexes or other similar agreements equal to the number of their execution counterparties *multiplied* by their number of clearing members (*multiplied* further perhaps by the number of clients' individual accounts in the case of multi-account asset managers). In addition to these legal costs, the administration of the trilateral execution agreement or other credit intermediation arrangements requires processes and infrastructure for delivering, tracking, adjusting and monitoring credit limit notices and sub-limit administration that not only do not presently exist but also have not been contemplated or designed. Putting this in place alone would be a costly multi-year endeavor that would needlessly encumber the introduction of central clearing for OTC derivatives. Diverting industry resources to both unnecessary legal costs and the construction of a superfluous regime for sub-limit administration is inadvisable and provides an opportunity for cost savings. In contrast, finalizing a sound, proven, and forward-looking market infrastructure for OTC derivatives clearing that benefits all market participants is an efficient use of such resources and advances the central goals of EMIR.
- Costs are incrementally minimal: CCPs and CMs already have systems in place in other cleared derivatives markets, including the energy derivatives market, that support real-time clearing acceptance without unnecessary and burdensome trilateral execution agreements or other credit intermediation arrangements. These systems are adapted for the clearing of other OTC derivatives, and this process has been underway for a number of years already.
- Costs have already been factored into industry's investment plans: Derivatives dealers, clearing members, CCPs and trading venues are already bringing offerings to market, or plan to launch offerings between now and when the mandatory clearing rules are anticipated to come into effect, that will support real-time clearing acceptance.



#### **Annex 4**

##### **Extract of the final CFTC straight-through-processing rule for reference**

Access to the full CFTC rules, including the preamble and CFTC's discussion of the responses to its notice of proposed rulemaking on straight-through-processing, can be obtained by activating the following hyperlink.

<http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-7477a.pdf>

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.<sup>127</sup> 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 × 60 hours] per affected registrant or \$932,400 [\$3,600 × 259 registrants] in the aggregate.

#### 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.

For the reasons stated in the preamble, amend 17 CFR parts 1, 23, 37, 38, and 39 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 by revising paragraph (a-1)(5)(iv) 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 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 timeframes set forth in § 1.74(b), § 23.610(b), or § 39.12(b)(7) of this chapter.

■ 4. Add § 1.73 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 (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 (ii) as applicable;

(B) The futures commission merchants that clear the allocated trades

<sup>127</sup> <http://www.bls.gov/oes/current/oes113031.htm>.

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 (17 CFR 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 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 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 subpart I to read as follows:

**Subpart I—Swap Documentation**

Sec.

23.500–23.505 [Reserved]

23.506 Swap processing and clearing.

**Subpart I—Swap Documentation**

**§§ 23.500–23.505 [Reserved]**

**§ 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 subpart J, as added at 77 FR 20128, April 3, 2012, effective June 4, 2012, 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 timeframes set forth in § 1.74(b), § 23.610(b), or § 39.12(b)(7) of this chapter.

■ 10. Add § 23.609 to subpart J, as added at 77 FR 20128, April 3, 2012, effective June 4, 2012, 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 subpart J, as added at 77 FR 20128, April 3, 2012, effective June 4, 2012, 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 subpart J, as added at 77 FR 20128, April 3, 2012, effective June 4, 2012, 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.

■ 13–14. Revise part 37 to read as follows:

## **PART 37—SWAP EXECUTION FACILITIES**

Sec.

### **Subparts A–G [Reserved]**

### **Subpart H—Financial Integrity of Transactions**

37.700 [Reserved]  
37.701 [Reserved]  
37.702 General financial integrity.  
37.703 [Reserved]

### **Subparts I–K [Reserved]**

**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.

### **Subparts A–G [Reserved]**

### **Subpart H—Financial Integrity of Transactions**

#### **§ 37.700 [Reserved]**

#### **§ 37.701 [Reserved]**

#### **§ 37.702 General financial integrity.**

(a) [Reserved]

(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.

#### **§ 37.703 [Reserved]**

### **Subparts I–K [Reserved]**

## **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.

■ 16. Designate existing §§ 38.1 through 38.6 as the contents of added subpart A under the following heading:

### **Subpart A—General Provisions**

\* \* \* \* \*

■ 17. Add subpart L to read as follows:

### **Subpart L—Financial Integrity of Transactions**

Sec.

38.600 [Reserved]  
38.601 Mandatory clearing.  
38.602–38.606 [Reserved]

### **Subpart L—Financial Integrity of Transactions**

#### **§ 38.601 [Reserved]**

#### **§ 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.

#### **§§ 38.602–38.606 [Reserved]**

## **PART 39—DERIVATIVES CLEARING ORGANIZATIONS**

■ 18. 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**

■ 19. In § 39.12, add paragraphs (a)(1)(vi) and (b)(7) 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.

\* \* \* \* \*

(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.

[FR Doc. 2012-7477 Filed 4-6-12; 8:45 am]

**BILLING CODE 6351-01-P**



## **Annex 5**

### **Proposed RTS Mandating Straight-Through-Processing of Transactions from the Non-Cleared to the Cleared State pursuant to EMIR Article 11**

EMIR Article 11 requires counterparties that enter into an OTC derivative contract not cleared by a CCP to measure, monitor and mitigate operational risk and counterparty credit risk transaction. This regulatory technical standard prescribes procedures that provide for the elimination of the risks associated with non-cleared transactions that are entered into with the intention to be cleared by requiring electronic, fully automated straight-through-processing (“STP”), where available, of the transaction upon execution, regardless of mode of execution, thereby, (1) minimizing or eliminating any period during which the transaction is not cleared, (2) eliminating bilateral counterparty credit risk, (3) providing immediate notice of non-acceptance of a derivative transaction for clearing and therefore eliminating financial loss in the event of such non-acceptance, (4) ensuring there is a comprehensive real-time record of effective derivatives transactions, and (5) mitigating operational risk, including the risk associated with incomplete transactions.

Clearing of OTC derivatives transactions must be processed with electronic, fully automated STP (where available), regardless of the mode of execution of the derivative transaction. All participants in the post-execution workflow must provide for automated processing so as to ensure immediate clearing acceptance (including coordinating with CCPs as required and complying with their protocols for data and messaging), whether through completion of all post-execution steps required to secure immediate post-execution clearing acceptance confirmation to the executing counterparties, or through provision for pre-execution guarantees combined with automated post-execution transaction processing to provide immediate clearing acceptance confirmation, in each case without regard to the mode of transaction execution. “Immediate” for purposes of these regulatory technical standards means the processing timeframe that can be achieved through industry-standard fully automated electronic processing, with no manual processing involved.

This means, at the first level: (1) for transactions executed on a trading venue, immediately upon execution the transaction is dispatched to the CCP and the CCP returns immediately, through continuous automation, a message to the trading venue and through the trading platform to the transaction counterparties confirming acceptance or non-acceptance of the executed transaction for clearing; and (2) for transactions executed by voice, from the moment the transaction is entered into a transaction capture facility that is connected, through open access, to the CCP, and matched by that transaction capture facility, the transaction is dispatched to the CCP and the CCP returns immediately, through continuous automation, a message to the transaction capture facility and through the transaction capture facility to the transaction counterparties confirming acceptance or non-acceptance of the transaction for clearing.

To effectuate the foregoing provisions:

CCPs must provide for fully automated STP of all matched transactions immediately upon receipt. It is understood that before a CCP can formally accept a matched transaction for

clearing, it may need to perform checks to confirm that the transaction falls within the credit limits of the counterparties and/or their clearing members, or in the alternative have the capacity to take into account or provide pre-execution clearing guarantees. All CCPs shall have automated facilities to perform these checks, and clearing members shall provide the necessary credit limits and/or checks as follows.

In particular:

To ensure STP of transactions between direct clearing members and/or guaranteed by direct clearing members, the CCP shall determine risk limits for each direct clearing member and shall maintain automated facilities either to (1) verify against such credit limits the credit available for each transaction as it is processed or (2) provide pre-execution guaranteed limits, including to trading venues, so as to allow STP of executed transactions.

To ensure STP of transactions further involving one or more clients, one or more of the following automated STP workflow approaches shall be utilized:

(1) the CCP shall provide facilities to clearing members to set client credit limits, and clearing members shall utilize these facilities to set client credit limits, the CCP shall check each client transaction against such credit limits through real-time automation upon receipt of the matched transaction details, and thereby the CCP shall process all client checks, together with direct clearing member checks, through real-time automation; or

(2) the CCP shall provide facilities such that for each client transaction, a real-time automated check is made with the client's clearing member, the clearing member must process such request in automated real-time and respond immediately to the CCP as to whether the clearing member accepts such transaction or rejects it; or

(3) the CCP shall administer facilities and agreements to provide for immediate, automated acceptance of client transactions entered into pursuant to a prior guarantee provided by the client's clearing member and supported by the clearing member's contractual commitment to the CCP to accept such transaction. For example, a clearing member may stipulate with a trading venue that a client may transaction freely within a specific limit, and concurrently will represent to the CCP that any matched transaction involving the client and designating that clearing member that is dispatched to the CCP is guaranteed for acceptance by the clearing member. In this instance, the CCP must have facilities to process such transaction as accepted by the clearing member, with STP.

In each case, the clearing member shall maintain risk-based limits for each of its clients, and, depending on the workflow elected in respect of a particular transaction, shall ensure that automated STP validation of the transaction against that limit is provided for in a way coordinated with the transaction workflows of the CCP to ensure that STP of client transactions transaction is effectuated through continuous automation and with no latency introduced by manual verification.

All transactions transaction not executed on an organized trading venue and intended to be cleared by a CCP are required to be entered not more than fifteen minutes from execution into a transaction capture facility that will transmit the transaction to the relevant CCP for clearing acceptance. ESMA may reduce this time period through subsequent administrative action. Exceptions to this rule may be granted only upon submission.

CCPs must communicate the acceptance or non-acceptance of a transaction for clearing immediately upon receipt and process the clearing request through fully automated processing and messaging systems.

CCPs are prohibited from adopting rules or engaging in conduct that is prejudicial to clients of clearing members as compared to direct clearing members with respect to eligibility to clearing, or the timing of clearing, or processing of transactions generally.

To prevent anti-competitive restrictions on clients' access to clearing, and to ensure no interruptions in STP that would create unnecessary counterparty credit or operational risk, the following provisions shall apply:

No clearing member providing clearing services to clients or CCPs shall enter into an arrangement that:

- (1) discloses to the clearing member the identity of a client's original executing counterparty;
- (2) limits the number of counterparties with whom a client may enter into a transaction;
- (3) restricts the size of the position a client may take with any individual counterparty, apart from an aggregate limit for all positions guaranteed by the clearing member for the client;
- (4) impairs a client's access to sourcing competitive execution of a transaction in the effort to secure the best pricing and other terms available; or
- (5) prevents compliance with the requirements in this regulatory technical standard imposed on all counterparties to a transaction and all parties involved in post-execution processing of the transaction that such processing be through automated STP in real time.

In light of the foregoing regulatory technical standards eliminating or substantially minimizing the period during which a transaction is not cleared, and in order to eliminate any bilateral counterparty credit risk in the execution and processing of OTC derivatives transactions intended to be cleared by a CCP, no party to a transaction shall impose on any other party the obligation, as a condition to enter into the transaction, to enter into an agreement regulating bilateral counterparty credit risk or "breakage," unless subject to a specific exception granted upon application by ESMA.

Aggregated transactions and allocation:

When a person performing investment management services (“**investment manager**”), in the course of performing such investment management services, aggregates orders on behalf of multiple clients for execution (“**block transaction**”) and engages in post-execution allocation of that block transaction to individual accounts for clearing:

- (1) the clearing member that initially undertakes the clearing of the block transaction shall establish risk-based credit limits for the block transaction account and screen the order in accordance with the foregoing requirements regarding STP;
- (2) The clearing members that clear the allocated transactions on behalf of the investment manager’s clients (“**underlying clients**”) shall establish risk-based credit limits for each underlying client and enter into an agreement in advance with the investment manager that requires the investment manager to screen allocations of the block transaction for compliance with those credit limits promptly following execution of a block transaction; and
- (3) The clearing members that clear the allocated transactions on behalf of the underlying clients shall establish and maintain systems of risk management controls reasonably designed to ensure compliance with the credit limits.