

## CFTC Adopts Swap Clearing Documentation, Timing and Risk Management Rules

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On March 20, 2012, the CFTC finalized a package of rules related to swap clearing. The rules set standards for:

- the arrangements that swap dealers (“**SDs**”), major swap participants (together with swap dealers, “**Swap Entities**”) and futures commission merchants (“**FCMs**”) that clear swaps for customers and derivatives clearing organizations (“**DCOs**”) have with respect to clearing customers;
- timing of acceptance or rejection of trades for clearing by DCOs and clearing members that are FCMs or Swap Entities (“**Clearing Members**”);
- risk management procedures of Clearing Members; and
- swap processing.

According to the CFTC, the three overarching themes being addressed are:

- non-discriminatory access to counterparties and clearing;
- straight-through processing; and
- effective risk management among Clearing Members.

The rules will generally become effective on October 1, 2012. For Swap Entities, the rules will become effective on the later of October 1, 2012 and the date on which registration is required. For swap execution facilities (“**SEFs**”), the rules will become effective on the later of October 1, 2012 and the date on which the rules implementing the SEF core principles become effective. Given this timeline and recent statements by CFTC Chairman Gary Gensler that a “possible start date for mandatory clearing ... could be as early as this summer,” it is conceivable that swap market participants, including those that will be customers of clearing members, will have to clear swaps before the effective date of the rules on timing of acceptance and rejection of trades for clearing.

### Customer Clearing Documentation

The CFTC has adopted, virtually unchanged, controversial proposed provisions relating to the arrangements that Clearing Members and DCOs have with respect to clearing customers. Most importantly, the provisions would prohibit tri-party agreements in which an FCM Clearing Member could limit the number or size of swaps with a specific executing counterparty that the Clearing Member would clear for a customer. This appears to have been motivated by a template annex for tri-party arrangements that had been developed by industry groups for optional use in negotiating execution-related documentation between SDs and their customers. Pursuant to the annex, a customer's FCM, in consultation with the SD, could set credit limits for the customer's swap transactions with the SD and agree to accept for clearing those transactions that fall within those limits. The intent of the annex was to increase certainty that swaps would be accepted for clearing, thereby reducing potential credit exposure and risk management costs. The CFTC was concerned, however, that by giving FCMs the ability to set sub-limits on the positions a customer can clear with a specific SD, FCMs could influence the amount of business a customer could do with specific counterparties, including SDs affiliated with that FCM. In the CFTC's view, this could reduce competition among SDs and impede the ability of counterparties to have their orders filled at the best available terms in the market at the time. In addition, communicating reductions in such “sub-limits” during times of market stress could signal false information regarding counterparty credit, making it more difficult for counterparties to trade.

Specifically, the final rules prohibit DCOs, FCMs providing clearing services to customers and Swap Entities entering into swaps to be submitted for clearing with customers of an FCM from entering into an arrangement that would:

- disclose to the FCM or any Swap Entity the identity of a customer's original executing counterparty;
- limit the number of counterparties with whom a customer may enter into a trade;
- restrict 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 FCM or with the Swap Entity;
- impair a customer's access to execution of a trade on terms that have a reasonable relationship to the best available terms; or
- prevent compliance with specified time frames for acceptance of trades into clearing.

The CFTC explicitly notes that these provisions are only meant to govern execution with third parties and do not prohibit Swap Entities from establishing their own trading limits with individual counterparties. In addition, the CFTC stated that Swap Entities may require that a counterparty confirm that it has an account with an FCM through which the counterparty will clear.

## Submission and Acceptance of Swaps for Clearing

The final rules establish a general framework for the submission and acceptance of swaps for clearing through the various possible permutations of swap execution.

### Submission of Off-facility Swaps

The rules establish both specific timing and other general requirements for Swap Entities to submit swaps not executed on a SEF or designated contract market ("**DCM**") ("**off-facility swaps**") for clearing on a DCO. Swap Entities must ensure that they have the capacity to route off-facility swaps to a DCO in a manner acceptable to the DCO for clearing purposes and must coordinate with the DCO to facilitate "prompt and efficient" trade processing. This provision is general enough to allow DCOs to permit routing of off-facility swaps directly to the DCO or through third-party platforms and to determine the role of Clearing Members in the process.

More specifically, the final rules require off-facility swaps required to be cleared to be submitted to the DCO as soon as technologically practicable after execution but no later than by the close of business on the date of execution. In contrast, off-facility swaps that are not required to be cleared, but are cleared by election of the parties, must be submitted no later than the business day after execution of the swap or, if later, the agreement to clear. "Business day" is not defined in order to allow flexibility for market participants.

### Submission of On-facility Swaps

While there is no explicit timing requirement for the submission for clearing of swaps executed on a DCM or SEF ("**on-facility swaps**"), several interconnected rules applicable to SEFs, DCMs and DCOs establish a framework for the "prompt, efficient and accurate processing" of such transactions for clearing. The rules require that transactions executed on or through a DCM (other than security futures) must be cleared on a DCO, and that the DCM must work with DCOs to ensure "prompt and efficient" transaction processing so that the DCO can comply with its own requirements for prompt transaction processing. Similarly, the rules require SEFs to coordinate with DCOs to route transactions in a manner acceptable to the DCO and develop rules and procedures to comply with the prompt transaction processing requirements. The CFTC declined to require SEFs and DCMs to ensure "equal access" to all DCOs that wish to clear trades executed on their platforms. The CFTC did, however, leave open the possibility of adopting additional requirements in the future.

## Acceptance for Clearing

The final rules require Clearing Members and DCOs to accept or reject contracts for clearing “as quickly as would be technologically practicable if fully automated systems were used.” While the CFTC explains that this standard is intended to approximate real-time acceptance within milliseconds, seconds or (at most) a few minutes, it does raise a question how a manual process could ever operate at the same speed as a fully automated system. Clearing Members may meet this requirement by establishing systems:

- to pre-screen orders for compliance with criteria specified by the clearing member;
- that authorize a DCO to accept or reject on its behalf trades that meet, or fail to meet, criteria specified by the clearing member; and
- that enable the clearing member to communicate to the DCO acceptance or rejection of each trade as quickly as would be technologically practicable if fully automated systems were used.

A DCO must accept all trades for which:

- executing parties have clearing arrangements in place with clearing members of the DCO;
- executing parties identify the DCO as the intended clearing house;
- the swap satisfies the non-discriminatory criteria (with respect to trading venue and clearing participant) of the DCO; and
- in the case of an off-facility swap, the specific submission timing requirements are met.

With this final rule, the CFTC stopped short of requiring DCOs to accept or reject swaps executed on a DCM or SEF immediately, noting that the rule was intended to strike a balance between the CFTC’s belief that acceptance or rejection for clearing as close to real time as possible is crucial to risk management and efficiency, and the DCO’s need to evaluate and aggregate the risk of incoming trades to determine whether trading or credit limits for a clearing member or customer are not exceeded.

As with the daily trade record requirements in the CFTC’s final internal business conduct rules, the CFTC has delegated to its staff the ability to establish an alternative compliance schedule to comply with clearing acceptance provisions that are “technologically or economically impracticable.”

## Post-trade Allocation of Bunched Orders

The final rules permit post-execution allocation of swap transactions executed as a block (“**bunched orders**”). Allocation must occur as soon as practicable after the transaction is executed but, for cleared trades, 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. Allocation for uncleared trades must occur no later than the end of the calendar day on which the swap is executed.

## Risk Management

In order to limit the risks posed by and to Clearing Members by customer clearing, the rules require each Clearing Member to<sup>1</sup>:

- establish risk-based limits in its proprietary account and, additionally for FCMs, in its customer account, based on position size, order size, margin requirements or similar factors;

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<sup>1</sup> These requirements apply not only to swaps, but also futures, security futures, commodity options and other enumerated agreements.

- screen orders to ensure compliance with risk-based limits (including for FCM Clearing Members, in the case of “give-ups,” screening by the clearing FCM to set limits for the customer and entering into an agreement in advance with the executing firm requiring the executing firm to screen orders for compliance with those limits and, in the case of bunched orders, screening by both the FCM who clears the block and the FCMs that clear the allocated trades);
- monitor for adherence to the risk-based limits intra-day and overnight;
- conduct stress tests, under extreme but plausible conditions, of all positions in each account that could pose material risks to the Clearing Member at least weekly, though no specific stress test levels are mandated and the stress tests will not be made public;
- evaluate its ability to meet initial margin requirements at least weekly;
- evaluate its ability to meet variation margin requirements in cash at least weekly;
- evaluate its ability to liquidate the positions it clears in an orderly manner and estimate the cost of liquidation, which is required quarterly for FCMs; and
- test all lines of credit at least annually (to ensure that a Clearing Member and its staff know how to access the line quickly and reliably when needed).

Clearing Members are required to establish written policies to comply with the risk management rules and keep full, complete and systematic records. These records must be available to the CFTC and relevant prudential regulators promptly upon request.

In providing general requirements for Clearing Member risk management, but not detailed procedures that must be followed, the CFTC has “intentionally drafted [the rules] in a non-prescriptive manner” in order to allow firms to make judgment calls based on their own risk profile, including customer base, resources and risk appetite.

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If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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