



## U.S. COMMODITY FUTURES TRADING COMMISSION

Three Lafayette Centre  
1155 21st Street, NW, Washington, DC 20581  
Telephone: (202) 418-5430  
Facsimile: (202) 418-5536

September 26, 2013

To:

All CFTC registered Futures Commission Merchants (“FCMs”)  
All CFTC temporarily registered Swap Execution Facilities and applicants for temporary registration as Swap Execution Facilities (“SEFs”)  
All CFTC registered Designated Contract Markets (“DCMs”)  
All CFTC registered Derivatives Clearing Organizations (“DCOs”)

### **Staff Guidance on Swaps Straight-Through Processing**

The Divisions of Market Oversight (“DMO”) and Clearing and Risk (“DCR”) (together “the Divisions”) of the Commodity Futures Trading Commission (“Commission”) are issuing this joint guidance (“Guidance”) to remind FCMs, SEFs, DCMs, and DCOs of their obligations to comply with certain Commission regulations with respect to swap trades on a SEF or DCM that are intended to be cleared. These obligations relate to the clearing of swaps that are traded on or through the facilities of SEFs or DCMs and cleared at DCOs by FCMs that are clearing members of the DCO (“Clearing FCMs”).

#### **I Pre-Execution Risk Management by Clearing FCMs**

Commission Regulation 1.73 (Clearing futures commission merchant risk management) imposes risk management requirements on Clearing FCMs. The Divisions remind Clearing FCMs that they are responsible for compliance with all requirements of Regulation 1.73.

Specifically, Regulation 1.73(a)(1) requires each Clearing FCM to establish risk-based limits for each proprietary account and each customer account that are based on position size, order size, margin requirements, or similar factors. Regulation 1.73(a)(2) requires each Clearing FCM to screen orders for compliance with those limits.<sup>1</sup>

Regulation 1.73(a)(2)(i) states that when a Clearing FCM provides electronic market access to a DCM or SEF or accepts orders for automated execution on a DCM or SEF, it shall use automated means to screen orders for compliance with such risk-based limits.<sup>2</sup> The Divisions note that the requirements of Regulation 1.73(a)(2)(i) apply to orders placed pursuant to a request for quote procedure, if the means of order execution is automated.

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<sup>1</sup> See 17 C.F.R. § 1.73(a)(1)-(2).

<sup>2</sup> See 17 C.F.R. § 1.73(a)(2)(i).

Regulation 1.73(a)(2)(ii) provides that when a clearing FCM accepts orders for non-automated execution, it shall establish and maintain systems of risk controls reasonably designed to ensure compliance with the limits.<sup>3</sup> The Commission has noted that orders executed by non-automated means (e.g., voice broker) can be screened automatically if they are routed automatically.<sup>4</sup>

Regulation 1.73(a)(2)(iii) provides that when a clearing FCM accepts transactions that were executed bilaterally and then submitted for clearing, it shall establish and maintain systems of risk controls reasonably designed to ensure compliance with the limits.<sup>5</sup>

The Divisions note that subparagraphs (i) and (ii) apply to “orders” while subparagraph (iii) applies to “transactions.” In addition, subparagraph (iii) is limited to transactions executed “bilaterally.” By contrast, the Commission stated in the preamble that subparagraph (i) in the Federal Register refers to “automated trading systems” such as Globex and the discussion of subparagraph (ii) refers to “non-automated markets such as open outcry exchanges or voice brokers.”<sup>6</sup> Because the Commission affirmatively included voice brokers in connection with subparagraph (ii), transactions executed through voice brokers do not fall under subparagraph (iii).

The distinctions among these subparagraphs have several implications. Because SEFs and DCMs are multilateral trading facilities, trades executed on or subject to the rules of such platforms are not bilateral trades for the purposes of Regulation 1.73(a)(2)(iii). For the purposes of this provision, bilateral trades are transactions not intended for clearing. Thus, the creditworthiness of each party is a material factor at the time of execution for bilateral trades. Accordingly, Clearing FCMs must screen orders for execution on a SEF or DCM pursuant to either Regulation 1.73(a)(2)(i) or (ii) regardless of the method of execution. The provisions of Regulation 1.73(a)(2)(iii) only apply where two parties transact directly with one another, outside of a trading facility. As noted above, this letter only applies to orders intended for clearing.

## II Pre-Execution Clearing Arrangements and Clearing FCM Guarantee of SEF and DCM Trades

Regulations 1.74, 37.702(b), 38.601, and 39.12(b)(7) establish straight-through-processing (“STP”) requirements for FCMs, SEFs, DCMs, and DCOs respectively.<sup>7</sup> A near-instantaneous acceptance or rejection of each trade provides certainty of execution and clearing, reduces costs, and decreases risk.

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<sup>3</sup> See 17 C.F.R. § 1.73(a)(2)(ii).

<sup>4</sup> See Customer Clearing Documentation, Timing of Acceptance for Clearing, and Clearing Member Risk Management, 77 Fed. Reg. at 21,288.

<sup>5</sup> See 17 C.F.R. § 1.73(a)(2)(iii).

<sup>6</sup> See Customer Clearing Documentation, Timing of Acceptance for Clearing, and Clearing Member Risk Management, 77 Fed. Reg. at 21,288.

<sup>7</sup> *Id.* at 21,285.

In order to achieve STP, Regulations 1.74, 37.702(b), 38.601, and 39.12(b)(7) each contain a provision requiring coordination with other registrants or registered entities. In particular, 37.702(b)(2) directs SEFs to have rules and procedures to facilitate prompt and efficient processing by DCOs in accordance with Regulation 39.12(b)(7). Subparagraph (ii) of 39.12(b)(7), in turn, requires DCOs to accept or reject all trades executed competitively on a SEF or DCM as quickly as would be technologically practicable as if fully automated systems were used.

The Divisions note that the Commission has previously stated, in the context of “multiple exchanges and clearinghouses for swaps” that “parties would need to have clearing arrangements in place with clearing members in advance of execution.”<sup>8</sup> The Commission further stated that “[i]n cases where more than one DCO offer[ed] clearing services, the parties also [would] need to specify in advance [of execution] where the trade should be sent for clearing.”<sup>9</sup> The Divisions also note that Number 20 of the List of Exhibits (Exhibit T) requires an applicant for SEF or DCM registration to provide, as part of Form SEF or DCM, a “list of the name[s] of the clearing organization(s) that will be clearing the Applicant’s trades, and a representation that clearing members of that organization will be guaranteeing such trades.”<sup>10</sup>

The interaction of the pre-execution risk controls in Regulation 1.73 with the STP requirements of Regulations 1.74, 37.702(b), 38.601, and 39.12(b)(7) has several consequences. First, because a SEF must “facilitate” STP under Regulation 37.702(b), no trade intended for clearing may be executed on or subject to the rules of a SEF unless a clearing member has been identified in advance for each party on an order-by-order basis. Second, a SEF must facilitate pre-execution screening by each Clearing FCM in accordance with Regulation 1.73 on an order-by-order basis. That is, the SEF should make it possible for Clearing FCMs to screen in accordance with Regulation 1.73 on an order-by-order basis. This is also consistent with the obligations of a SEF to provide impartial access under Regulation 37.202. Third, screening orders pursuant to Regulation 1.73 provides Clearing FCMs the ability to reject orders before execution. Therefore, orders which have satisfied the Clearing FCMs’ pre-execution limits are deemed accepted for clearing and thereby subject to a guarantee by the Clearing FCM upon execution. Accordingly, a Clearing FCM may not reject a trade that has passed its pre-execution filter because this would violate the requirement that trades should be accepted or rejected for clearing as soon as technologically practicable.<sup>11</sup>

### III Routing of Swap Transactions by SEFs to DCOs

Regulation 37.701 (Required clearing) provides that transactions executed on or through

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<sup>8</sup> *Id.* at 21,284.

<sup>9</sup> *Id.*

<sup>10</sup> *See* Core Principles and Other Requirements for Swap Execution Facilities, 78 Fed. Reg. 33,476 at 33,598 (June 4, 2013); Core Principles and Other Requirements for Designated Contract Markets, 77 Fed. Reg. 36,612 at 36,717 (June 19, 2012).

<sup>11</sup> *See* 17 C.F.R. § 1.74.

a SEF, which are required to be cleared or are voluntarily cleared, must be cleared through a Commission registered DCO or a DCO that is exempt from registration.<sup>12</sup> As of the date of this Guidance, the Commission has not exempted any DCO from registration.

Regulation 37.702 (General financial integrity) provides, among other things, that with respect to transactions cleared by a DCO, a SEF must ensure that it has the capacity to route transactions to the DCO in a manner acceptable to the DCO.<sup>13</sup> This means that it is the responsibility of SEFs to route transactions to a DCO for the purpose of clearing.

With respect to the permissibility of using so-called “affirmation hubs,” the Divisions note that the Commission has stated that “[i]f the DCO views the use of an affirmation hub as an acceptable means for routing the swap, the routing otherwise complies with [Regulation] 37.702(b), and the trade is processed in accordance with the standards set forth in [Regulations] 1.74, 39.12., 23.506, and 23.610 of the Commission’s regulations, then the use of an affirmation hub for routing a swap to a DCO for clearing would be permissible.”<sup>14</sup> However, the Divisions remind participants that the trade must still be routed “as quickly after execution as would be technologically practicable if fully automated systems were used.”<sup>15</sup> Use of a third party affirmation hub does not excuse compliance with this timing standard.

#### IV Routing of Swap Transactions by DCMs to DCOs

Regulation 38.601 (Mandatory clearing) provides that all transactions executed on or subject to the rules of a DCM must be cleared through a registered DCO. The regulation further obliges DCMs to coordinate with each DCO to which they submit transactions for clearing in the development of rules and procedures to facilitate prompt and efficient transaction processing in accordance with the requirements of Regulation 39.12(b)(7).<sup>16</sup> For the avoidance of doubt, the Divisions interpret this provision to mean that it is the responsibility of a DCM to submit an executed swap transaction to a DCO for clearing.

#### V Time frame for clearing of Swap Transactions Executed Competitively on DCMs and SEFs

Regulation 39.12(b)(7) requires a DCO to have rules that provide that the DCO 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 DCO and are executed competitively on or subject to the rules of a DCM or SEF.<sup>17</sup> As explained in the preamble to the rule, this standard was designed to accommodate developments in technology that continue to reduce trade processing times in order to minimize costs and enhance trade certainty.<sup>18</sup>

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<sup>12</sup> See 17 C.F.R. § 37.701.

<sup>13</sup> See 17 C.F.R. § 37.702(b)(1).

<sup>14</sup> See Core Principles and Other Requirements for Swap Execution Facilities, 78 Fed. Reg. at 33,535.

<sup>15</sup> See 17 C.F.R. § 39.12(b)(7).

<sup>16</sup> See 17 C.F.R. § 38.601.

<sup>17</sup> See 17 C.F.R. § 39.12(b)(7)(ii).

<sup>18</sup> See 77 Fed. Reg. 21,278 at 21,286.

DCR previously interpreted “as soon as technologically practicable” to be 60 seconds. Recent data received by DCR shows that DCOs now accept at least 93% of trades within three (3) seconds or less, and 99% of trades within ten (10) seconds or less. Accordingly, “as soon as technologically practicable” is now within 10 seconds. Therefore, DCOs clearing swaps that are executed competitively on or subject to the rules of a DCM or SEF and are accepting or rejecting trades within 10 seconds after submission are compliant with the timing standard of Regulation 39.12(b)(7). DCR expects DCOs to contemporaneously notify the relevant DCM or SEF and clearing FCMs whether a trade has been accepted or rejected.

## VI Effect of Rejection from Clearing

The price of a swap depends, in part, on whether it is intended to be cleared. Consequently, if a swap that is intended to be cleared is rejected, a material term to the contract is unfulfilled. Therefore, the Divisions believe that any trade that is executed on a SEF or DCM and that is not accepted for clearing should be void *ab initio*.<sup>19</sup>

This result is consistent with Section 22(a)(4)(B) of the Act.<sup>20</sup> That provision must be read in conjunction with Section 2(h) which requires certain swaps to be cleared. Section 22 is captioned “Private Rights of Action” and paragraph (a)(4) is captioned “Contract Enforcement Between Eligible Counterparties.” Section 22(a)(4)(B) of the Act prohibits participants in a swap from voiding a trade. It does not prohibit the Commission or a SEF from declaring a trade to be void. If it were to be read otherwise, it would enable parties to evade the clearing requirement by deliberately entering trades that exceeded their credit limits and then enforcing them as bilateral trades.

Experience indicates that pre-trade checks will make rejection a rare event and that STP has made the time between execution and any rejection a matter of seconds. This combination of rarity and minimal financial exposure to the parties obviates the need to have so-called “breakage agreements” between market participants.<sup>21</sup> The imposition of such agreements would be an impairment to impartial access to SEFs.<sup>22</sup>

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<sup>19</sup> This would not apply to backloaded trades; that is, trades originally executed without an intent to clear, where the parties subsequently decide to clear the trades.

<sup>20</sup> Section 22(a)(4)(B) of the CEA states that “[n]o agreement, contract, or transaction between eligible contract participants or persons reasonably believed to be eligible contract participants shall be void, voidable, or unenforceable, and no party to such agreement, contract, or transaction shall be entitled to rescind, or recover any payment made with respect to, the agreement, contract, or transaction under this section or any other provision of Federal or State law, based solely on the failure of the agreement, contract, or transaction (i) to meet the definition of a swap under section 1a of this title; or (ii) to be cleared in accordance with section 2(h)(1) of this title.”

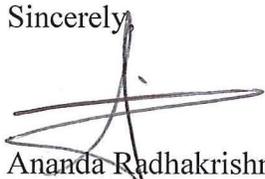
<sup>21</sup> For these reasons, breakage agreements are not used in the futures markets.

<sup>22</sup> See Section 5h(f)(2) of the Act and 17 C.F.R. § 37.202 (“A swap execution facility shall provide any eligible contract participant and any independent software vendor with impartial access to its market(s) and market services, including any indicative quote screens or any similar pricing data displays . . .”).

Accordingly, the Divisions expect DCMs and SEFs to have rules stating that trades that are rejected from clearing are void *ab initio*. Further, DCMs, SEFs, FCMs,<sup>23</sup> and swap dealers<sup>24</sup> should not require breakage agreements as a condition for access to trading on a SEF or DCM.

This Guidance supersedes any previous guidance issued by the Divisions on these topics. This staff guidance, and the positions taken herein, represent the views of the Divisions only, and do not necessarily represent the view of the Commission or of any other office or division of the Commission. If you have any questions concerning this guidance, please call Nancy Markowitz, Deputy Director, 202-418-5453 [nmarkowitz@cftc.gov](mailto:nmarkowitz@cftc.gov), or Amir Zaidi, Special Counsel, 202-418-6770, [azaidi@cftc.gov](mailto:azaidi@cftc.gov), DMO or John C. Lawton, Deputy Director, 202-418-5480, [jlawton@cftc.gov](mailto:jlawton@cftc.gov), or Christopher Hower, Special Counsel, 202-418-6703, [chower@cftc.gov](mailto:chower@cftc.gov), DCR.

Sincerely,



Ananda Radhakrishnan  
Director, DCR



Nancy Markowitz  
Deputy Director, DMO



David Van Wagner  
Chief Counsel, DMO

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<sup>23</sup> See 17 C.F.R. § 1.72.

<sup>24</sup> See 17 C.F.R. §§ 23.506, 23.608-23.610.