

CFTC Adopts Final Clearing, Risk Management and Bunched Order Rules

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Today, the Commodity Futures Trading Commission (CFTC) published in the Federal Register final rules intended to increase customer access to clearing, facilitate processing of trades and strengthen risk management at the clearing member level.¹ In furtherance of these purposes, the rules address the documentation between a customer and the futures commission merchant (FCM) that clears swaps on behalf of the customer; the timing of acceptance or rejection of trades for clearing by both derivatives clearing organizations (DCOs) and clearing members; and the risk management procedures of FCMs, swap dealers (SDs) and major swap participants (MSPs) that are clearing members. The final rules also provide limitations and requirements applying to allocation of bunched orders by account managers. The rules will become effective October 1, 2012, for FCMs, DCOs and designated contract markets (DCMs). Because the CFTC has not yet finalized its entity definitions for SDs or MSPs or finalized its core principles for swap execution facilities (SEFs), the rules will become effective for those entities as follows: 1) for SDs/MSPs, the later of October 1, 2012, or the date that SD/MSP registration rules become effective, and 2) for SEFs, the later of October 1, 2012, or the date the SEF core principles become effective.

Do the final rules prohibit trilateral clearing agreements?

No, the final rules do not explicitly prohibit all trilateral clearing agreements.² However, the final rules prohibit provisions in agreements related to clearing that would (i) disclose to the FCM, any SD or any MSP the identity of the customer's original executing counterparty; (ii) limit the number of counterparties with whom a customer may enter into a trade; (iii) restrict the size of position a customer may take with any counterparty (except an overall credit limit for all positions held by a customer at the FCM); (iv) impair the customer's access to execution of a trade on terms with a reasonable relationship to the best terms available; and (v) prevent compliance with the time limits imposed on submitting and accepting swaps into clearing discussed below.³ These prohibitions appear to be in response to the FIA-ISDA Cleared Derivatives Execution Agreement (FIA-ISDA Agreement),⁴ a form template agreement between swap counterparties, and, if optional annexes are included, their FCMs, developed by a trade association representing SDs and market participants and a trade association representing clearing firms (those that guarantee the financial performance of customers' trades to a DCO). Among other things, the FIA-ISDA Agreement contained optional annexes allowing clearing members affiliated with the FCM to become parties to the FIA-ISDA Agreement and impose limits on swaps exposures that the clearing member's customer could assume in swaps with unaffiliated counterparties (necessarily requiring disclosure of unaffiliated counterparties' identities to the clearing member). The CFTC state-

1 Customer Clearing Documentation, Timing of Acceptance for Clearing, and Clearing Member Risk Management, 77 Fed. Reg. 21,278 (Apr. 9, 2012).

2 77 Fed. Reg. at 21280.

3 Rule 1.72.

4 The FIA-ISDA Cleared Derivatives Execution Agreement is available at <http://www.futuresindustry.org/fia-and-isda-publish-documentation-for-cleared-swaps.asp>.

ment that the FIA-ISDA Agreement would “potentially conflict” with the final rules is expected to inhibit use of these optional annexes.

What time limits will be imposed on submitting and accepting swaps into clearing?

The final rules will impose straight-through processing, requiring that each SD, MSP, SEF or DCM (i) ensure that it is capable of routing swap transactions in accordance with these rules and (ii) coordinate with DCOs to ensure prompt and efficient transaction processing for their swaps.⁵

For trades executed on a SEF or DCM, the CFTC has refrained from imposing a specific length of time in which a clearing member must submit a swap to clearing. Rather, the final rules will require that any clearing member must take action to ensure swaps will be accepted or rejected from clearing “as quickly as would be technologically practicable if fully automated systems were used.”⁶ DCOs also would be required to impose rules enabling swaps to be accepted or rejected into clearing in the same amount of time.⁷

For trades not executed on a SEF or DCM that are subject to the clearing requirement, the final rules will require that the SD/MSP submit the swap for clearing as soon as technologically practicable after execution, but no later than the close of the business day on the day of execution.⁸ If the swap is not executed on a SEF or DCM and is being submitted for clearing by agreement, the final rules will require that the swap be submitted no later than the next business day after execution or the agreement to clear the swap.⁹ “Close of business day” is not defined in the rules, but is specified in the Federal Register notice as the close of business at the DCO where clearing is to occur.¹⁰

As part of the final rules, the CFTC has delegated to the Director of the Division of Clearing and risk the authority to grant exemptive relief, providing FCMs, SDs or MSPs for whom compliance with the rules would be technologically or economically impracticable with additional time to comply with the time limits.¹¹

What limitations do the final rules impose on allocating bunched orders?

The final rules also impose time limits on “bunched orders,” which are orders entered by an account manager that are executed as a block and allocated after execution to customers so the trades may be cleared. The final rules will require that bunched orders be allocated as soon as practicable after execution, but also provides absolute deadlines by which allocation must occur.¹² For trades that are cleared, allocation must occur sufficiently before the end of the day the order is executed to ensure that clearing records may identify the ultimate customer for each trade.¹³ For uncleared trades, the account manager must provide allocation information to the counterparty no later than at the end of the calendar day the swap was executed.¹⁴ Account managers are required to provide for fair and

5 Rule 23.506(a); Rule 37.702(b); Rule 38.601.

6 Rule 1.74; Rule 23.610.

7 Rule 39.12(b)(7)(i).

8 Rule 23.506(b)(1).

9 Rule 23.506(b)(2).

10 77 Fed. Reg. at 21283.

11 Rule 1.75; Rule 23.611.

12 Rule 1.35(a-1)(5)(iv)(A).

13 Rule 1.35(a-1)(5)(iv)(A).

14 Rule 1.35(a-1)(5)(iv)(A).

equitable allocations and are forbidden from giving any account or group of accounts consistently favorable or unfavorable treatment relative to other accounts.¹⁵

What trades must a derivatives clearing organization accept for clearing?

In addition to imposing the time frames discussed above, the final rules identify the trades that a DCO must accept for clearing. A DCO will be required to accept any trades executed on a DCM or SEF if (i) the executing parties have clearing arrangements with a clearing member of the DCO, (ii) the executing parties designated the DCO as the intended clearinghouse, and (iii) the trade meets the DCO's nondiscriminatory criteria and applicable risk filters.¹⁶

What risk management obligations will clearing members have?

Clearing FCMs will be required to establish risk-based limits for the proprietary account and each customer account based on position size, order size, margin requirements, or similar factors and screen orders for compliance with those risk-based limits.¹⁷ Clearing FCMs using automated execution will be required to use automated screening, but clearing members accepting trades by nonautomated means (for instance, by phone or open outcry) or FCM clearing members submitting transactions that were executed bilaterally and then submitted for clearing will be required only to "establish and maintain systems of risk controls reasonably designed to ensure compliance with the limits."¹⁸

A clearing FCM that is not serving as the executing FCM will be required to enter into an agreement that requires the clearing FCM to establish risk-based limits for the customer and the executing FCM to screen orders for compliance with those limits. Clearing FCMs will be required to monitor for adherence to the risk-based limits intraday and overnight.¹⁹

At least once a week, an FCM will be required to assess its ability to meet initial margin and variation margin requirements for its proprietary account and each customer account, while also conducting weekly stress tests under "extreme but plausible" conditions of all positions in the proprietary account and each customer account that could pose a material risk to the FCM.²⁰ An FCM will be required to evaluate its ability to conduct an orderly liquidation of positions in proprietary and customer accounts and estimate the cost of such liquidation at least quarterly.²¹ FCMs also will be required to test all lines of credit at least yearly.²²

Each clearing FCM will be required to adopt written procedures to comply with the risk management rules, maintain full, complete and systematic records documenting compliance with the risk management obligations, and make the records available to the CFTC and prudential regulators promptly upon request.²³

15 Rule 1.35(a-1)(5)(iv)(5).

16 Rule 39.12(7)(ii)-(iii).

17 Rule 1.73(a)(1)-(2).

18 Rule 1.73(a)(2)(ii)-(iii); Rule 23.609(a)(2)(i)-(ii).

19 Rule 1.73(a)(3); Rule 23.609(a)(3).

20 Rule 1.73(a)(4)-(6); Rule 23.609(a)(4)-(6).

21 Rule 1.73(a)(7); Rule 23.609(a)(7).

22 Rule 1.73(a)(8); Rule 23.609(a)(8).

23 Rule 1.73(b).