

## FINAL RULES FOR CLEARING DOCUMENTATION, TIMING OF ACCEPTANCE FOR CLEARING, AND CLEARING MEMBER RISK MANAGEMENT

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To Our Clients and Friends:

The Commodity Futures Trading Commission (the “CFTC”) has recently adopted final rules to implement (i) the prohibition of certain terms in the documentation between a customer and a futures commission merchant (“FCM”) that clears trades on behalf of the customer, (ii) the timing of acceptance and rejection of trades for clearing by a derivatives clearing organization (“DCO”) and its clearing members, and (iii) the risk management procedures of FCMs, Swap Dealers (“SDs”) and Major Swap Participants (“MSPs”) that are also clearing members.

Generally, these final rules will become effective on October 1, 2012, and can be found on the CFTC website at:

<http://cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister032012.pdf>

### CUSTOMER CLEARING DOCUMENTATION

The CFTC has issued final rules applicable to FCMs, SDs and MSPs that prohibit each of them from entering into with a customer (in the case of an FCM) or a counterparty that is a customer of an FCM (in the case of an SD or MSP), or requiring the entering into by such customer or counterparty of, any arrangement that:

- discloses to the FCM or any SD or MSP the identity of the customer’s original executing counterparty;
- limits the number of counterparties with whom a customer may enter into a trade;
- restricts the size of the position a customer may take with any individual counterparty, except for an overall limit for all positions of that customer at a FCM; or
- impairs a customer’s access to execution of a trade on terms that have a reasonable relationship to the best available terms.

In addition, the Final Rules prohibit a DCO from requiring, as a condition for accepting a swap for clearing, that an FCM enter into any arrangement described above with a customer.

The CFTC states that these rules are intended to prevent certain provisions that have been developed in the industry template documentation for clearing arrangements, which buy-side firms feared would allow an FCM to favor its affiliated execution desks to the detriment of the customer. The industry template documentation would also permit a customer's FCM to set specific credit limits on how many trades that customer can enter into with any SD-counterparty. The buy-side firms were concerned that an FCM, in setting those SD-specific credit limits, would favor its affiliated SD, which in turn would limit the number of executing counterparties a customer could actually use.

In the accompanying Release, the CFTC notes that disclosing a customer's original executing counterparty could have anti-competitive effects and limiting the number of counterparties or restricting the size of trades with particular counterparties could hurt a customer's access to best pricing, impede general market liquidity and slow down acceptance of trades for clearing.

The CFTC clarifies that these rules only apply to swaps and do not otherwise prohibit an SD or a MSP from setting bilateral limits with each of its counterparties. The rules also do not impair an SD's or a MSP's ability to conduct counterparty due diligence.

#### TIME FRAME FOR ACCEPTANCE INTO CLEARING

The CFTC sets the following time frame for the clearing of swaps not executed on a swap execution facility (a "SEF") or a designated contract market (a "DCM"):

- For each swap subject to mandatory clearing requirement, each SD or MSP must submit such swap for clearing to a DCO as soon as technologically practicable after its execution, but not later than the close of business of the day of execution.
- For each swap not subject to mandatory clearing requirement but accepted for clearing by a DCO, and for which an SD or MSP and its counterparty have elected for clearing, the SD or MSP must submit such swap for clearing not later than the next business day after the execution of such swap or the agreement to clear, if such agreement occurs after its execution.

In the accompanying Release, the CFTC states that the definition of "business day" will be left to the discretion of the DCOs so that each DCO can decide to expand its business hours to achieve a competitive edge in the marketplace.

To further promote efficient clearing, the CFTC has also issued a number of rules that mandate coordination among SDs, MSPs and the DCOs. Therefore, all SDs and MSPs must ensure that they have the capacity to route trades not executed on a SEF or DCM to a DCO in a manner acceptable to the DCO for clearing and must coordinate with all relevant DCOs to facilitate prompt and efficient processing of the trades. Similarly, all DCOs are required to coordinate with the DCMs and SEFs that list for trading a product that is cleared on those DCOs to develop rules and procedures to facilitate the prompt, efficient and accurate processing of swaps for clearing. All DCOs are also required to coordinate with each clearing member to establish systems that enable the clearing member or the DCO, acting for the clearing member, to accept or reject trades submitted for clearing as quickly as would be technologically practicable if fully automated systems were used.

In addition, the CFTC points out that, to accomplish the goal of the Dodd-Frank Act in promoting central clearing, it is imposing final rules to minimize time lag between execution of trades and submission for clearing; therefore, a DCO must have rules to accept or reject for clearing, as quickly as would be technologically practicable if fully automated systems were used, all contracts that are listed for clearing or that are submitted for clearing. Further, while the DCO may screen trades against applicable product and credit risk criteria before accepting or rejecting trades, if a trade satisfies the applicable criteria, the DCO must accept it for clearing.

#### CLEARING MEMBER RISK MANAGEMENT

The CFTC states that it is imposing rules on the clearing members to enforce certain risk management practices in order to reduce the potential systemic risk of central clearing. These risk management rules apply to FCMs, SDs and MSPs that are also clearing members of a DCO.

The clearing members must:

- establish certain risk-based credit and market limits for their trades, and for FCMs, also for the trades of their customers;
- establish and design control systems to screen orders and trades for compliance with the risk-based limits;
- monitor the trades for compliance to the risk-based limits on an intra-day and overnight bases;

- design and conduct weekly stress tests under extreme but plausible conditions of all of their positions, and for FCMs, also for all positions in their customers' accounts that would pose material risk to such FCMs;
- evaluate their ability to meet initial and variation margin requirements on at least a weekly basis;
- estimate their ability to liquidate, and the costs of liquidating, in an orderly manner, all of their positions, and for FCMs, also for all of their customers' positions, on a quarterly basis; and
- test the credit lines available to them at least once a year.

To enforce these risk management practices, the clearing members must establish written procedures to comply with the risk management rules and keep full, complete and systematic records documenting such compliance. All such records must be made available to the representatives of the CFTC or other prudential regulators upon request.

In the accompanying Release, in response to the comments that these risk management rules are too vague, the CFTC states that the rules are intentionally drafted in a non-prescriptive way, which should permit each clearing member to design the limits, tests and other procedures in a way that is appropriate to its business model and customer base.

#### EFFECTIVENESS OF THE RULES WITH RESPECT TO THE REGULATED ENTITIES

Generally, these rules will become effective on October 1, 2012, but the CFTC acknowledges that the actual application of these rules to SDs, MSPs and SEFs is not possible without finalization of the entity definition rulemaking for such entities. However, the CFTC urges entities currently expected to become SDs, MSPs and SEFs to start developing systems and procedures to comply with the rules. The CFTC goes on to clarify in the Release that the rules are effective for FCMs, DCMs and DCOs on October 1, 2012. However, the rules will be

effective for the SDs and MSPs on the later of October 1, 2012 and the effective date for the registration rules applicable to SDs and MSPs, and they will be effective for SEFs on the later of October 1, 2012 and the effective date of the rules implementing core principles for SEFs.

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