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Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants; Final Rule

COMMODITY FUTURES TRADING COMMISSION

17 CFR Part 23

RIN 3038–AC96

Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants

AGENCY: Commodity Futures Trading Commission.

ACTION: Final rule.

SUMMARY: The Commodity Futures Trading Commission (Commission or CFTC) is adopting regulations to implement certain provisions of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). Section 731 of the Dodd-Frank Act added a new section 4s(i) to the Commodity Exchange Act (CEA), which requires the Commission to prescribe standards for swap dealers (SDs) and major swap participants (MSPs) related to the timely and accurate confirmation, processing, netting, documentation, and valuation of swaps. These regulations set forth requirements for swap confirmation, portfolio reconciliation, portfolio compression, and swap trading relationship documentation for SDs and MSPs.

DATES: The rules will become effective November 13, 2012. Specific compliance dates are discussed in the **SUPPLEMENTARY INFORMATION.**

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SUPPLEMENTARY INFORMATION

Table of Contents

I. Background

The Commission is hereby adopting § 23.500 through § 23.505 [1] setting forth standards for the timely and accurate confirmation of swaps, requiring the reconciliation and compression of swap portfolios, and setting forth requirements for documenting the swap trading relationship between SDs, MSPs, and their counterparties. These regulations are being adopted by the Commission pursuant to the authority granted under sections 4s(h)(1)(D), 4s(h)(3)(D), 4s(i), and 8a(5) of the CEA. Section 4s(i)(1) of the CEA, requires SDs and MSPs to ''conform with such standards as may be prescribed by the Commission by rule or regulation that relate to timely and accurate confirmation, processing, netting, documentation, and valuation of all swaps.'' Documentation of swaps is a critical component of the bilaterally-traded, over-the-counter (OTC) derivatives market, while confirmation, portfolio reconciliation, and portfolio compression have been recognized as important post-trade processing mechanisms for reducing risk and improving operational efficiency. Each of these processes has been the focus of significant domestic and international attention in recent years by both market participants and their regulators.

II. Comments on the Notices of Proposed Rulemaking

The final rules adopted herein were proposed in three separate notices of proposed rulemaking.[2] Each proposed rulemaking was subject to an initial 60-day public comment period and a re-opened comment period of 30 days.[3] The Commission received a total of approximately 62 comment letters directed specifically at the proposed rules.[4] The Commission considered each of these comments in formulating the final regulations.[5]

The Chairman and Commissioners, as well as Commission staff, participated in numerous meetings with representatives of potential SDs and MSPs, trade associations, public interest groups, traders, and other interested parties. In addition, the Commission has consulted with other U.S. financial regulators including: (i) The Securities and Exchange Commission (SEC); (ii) the Board of Governors of the Federal Reserve System; (iii) the Office of the Comptroller of the Currency; and (iv) the Federal Deposit Insurance Corporation. Staff from each of these agencies has had the opportunity to provide oral and/or written comments to this adopting release, and the final regulations incorporate elements of the comments provided.

The Commission is mindful of the benefits of harmonizing its regulatory framework with that of its counterparts in foreign countries. The Commission has therefore monitored global advisory, legislative, and regulatory proposals, and has consulted with foreign regulators in developing the final regulations. Specifically, Commission staff has consulted with the European Securities and Markets Authority (ESMA), which has recently released a consultation paper for the regulation of OTC derivatives containing draft technical standards that are substantially similar to some of the rules adopted by the Commission in this release, as further noted below.[6]

A. Regulatory Structure

Several commenters raised general concerns with the legal authority for or structure of the proposed rules, or their possible effect on existing transactions.

1. Statutory Authority for the Proposed Rules

The Working Group of Commercial Energy Firms (The Working Group)

[1] Commission regulations referred to herein are found at 17 CFR Ch. 1.

[2] *See* 75 FR 81519 (Dec. 28, 2010) (Confirmation, Portfolio Reconciliation, and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants (Confirmation NPRM)); 76 FR 6715 (Feb. 8, 2011) (Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants (Documentation NPRM)); and 76 FR 6708 (Feb. 8, 2011) (Orderly Liquidation Termination Provision in Swap Trading Relationship Documentation for Swap Dealers and Major Swap Participants (Orderly Liquidation NPRM)).

[3] *See* 76 FR 25274 (May 4, 2011) (extending or re-opening comment periods for multiple Dodd-Frank proposed rulemakings).

[4] Comment files for each proposed rulemaking can be found on the Commission Web site, *www.cftc.gov.*

[5] The Commission also reviewed the proposed rule of the Securities and Exchange Commission concerning trade acknowledgement and verification of security-based swap transactions. *See* 76 FR 3859 (Jan. 21, 2011).

[6] *See* ESMA Consultation Paper 2012/379, Draft Technical Standards for the Regulation of OTC Derivatives, CCPs and Trade Repositories (June 25, 2012) (ESMA Draft Technical Standards).

commented that many of the specific provisions in the proposed rules are not required by section 731 of the Dodd-Frank Act and that such provisions are not ''reasonably necessary'' to achieve the goals of the CEA. The Working Group believes that the Commission could meet its statutory mandate by publishing principle-based rules, rather than the detailed approach of the proposed rules. Dominion Resources, Inc. (Dominion) also asserted that the proposed rules would achieve a regulatory scope beyond what is required by section 4s(i) and may require end users to change their business practices. Dominion requested that the proposed rules be further tailored to ensure the effect of the rules is limited to SDs and MSPs.

The Commission notes that section 731 of the Dodd-Frank Act added a new section 4s(i) to the CEA that states that each registered SD and MSP shall conform with such standards as may be prescribed by the Commission by rule or regulation that relate to timely and accurate confirmation, processing, netting, documentation, and valuation of all swaps. Section 4s(i) also states that the Commission shall adopt rules governing documentation standards for SDs and MSPs.

Swaps and swap trading relationship documentation are contractual arrangements that necessarily involve more than a single party. The Commission believes that the statutory requirement that the Commission adopt rules governing documentation standards relating to confirmation, processing, netting, documentation, and valuation of *all* swaps reflects the intent of Congress to have the Commission adopt rules that necessarily effect SDs, MSPs, and their swap counterparties. The Commission also believes the rules establish a set of documentation standards for prudent risk management for registered SDs and MSPs while minimizing the burdens on non-SDs and non-MSPs.

2. Application to Existing Swaps and Documentation

In response to a request for comment in the Documentation NPRM asking how long SDs and MSPs should have to bring existing swap documentation into compliance with the proposed rules and whether a safe harbor should be provided for dormant trade documentation, the International Swaps and Derivatives Association (ISDA) and the Securities Industry and Financial Markets Association (SIFMA), in a joint comment letter (ISDA & SIFMA), strongly urged the Commission to specify that only new transactions entered into after the effective date of the rules are subject to the rules' requirements, and that it is not mandatory to amend terms or agreements that apply to transactions entered into prior to such date. ISDA & SIFMA further argued that Commission rules relating to business conduct, the confirmation process, confidentiality and privacy, collateral segregation requirements, and margin and capital may all directly or indirectly require registrants to make amendments to existing relationship documentation, and that it would be extremely inefficient, time consuming and costly for registrants to engage in separate rounds of amendments with their trading counterparties for each set of Dodd-Frank Act rulemakings. ISDA & SIFMA recommended that registrants be permitted to develop plans to update their agreements in an integrated manner for the full range of Dodd-Frank Act requirements, and implementation timelines should reflect the requirements of such an approach, keeping in mind that those requirements will not be known until the scope and terms of all of the relevant Commission regulations (and those of the SEC) are more clearly delineated.

The Working Group and the Financial Services Roundtable (FSR) also urged the Commission to apply the rules to new swaps only, arguing that renegotiation of existing documentation would take significantly longer than six months; may be impossible in some cases; and is not a good use of limited resources of market participants that will already be taxed with the necessary changes mandated by the Dodd-Frank Act and the Commission's other rules. Likewise, the Coalition for Derivatives End-Users urged the Commission to exempt trades entered into before the enactment of the Dodd-Frank Act from the requirements of the rules and the Managed Funds Association (MFA) strongly objected to the Commission applying any of these requirements to existing contracts. MFA argued that section 739(5) of the Dodd-Frank Act specifically provides that the Dodd-Frank Act shall not constitute a ''regulatory change, or similar event * * * that would permit a party to terminate, renegotiate, modify, amend, or supplement one or more transactions under the swap.'' MFA believes that imposing these requirements on existing agreements would clearly require that existing agreements be ''renegotiated.''

The Federal Home Loan Banks (FHLBs) noted on the other hand that netting of pre-existing transactions with new transactions is critical to efficient hedging, and thus documentation for pre-existing swaps will need to be modified to maintain the benefits of netting.

Having considered these comments, the Commission agrees with commenters that the rules should not apply retrospectively and will require compliance with the rules only with respect to swaps entered after the date on which compliance with the rules is required, as discussed below. With respect to the comment of the FHLBs, the Commission notes that the rules would not prohibit parties from arranging their documentation to maintain the benefits of netting between pre-existing swaps and swaps entered after the date compliance with the rules is required if they so choose. In addition, with regard to ISDA & SIFMA's argument that swap trading documentation would need to be amended when rules relating to segregation and margin are finalized, the Commission observes that those rules are likely to provide for additional time for documentation to be brought into compliance.

3. Legal Certainty

With respect to the validity of transactions where the parties fail to comply with the rules, The Working Group argued that for the sake of legal certainty, a failure to comply with the proposed rules should not result in invalidation of swaps entered into under deficient swap trading relationship documentation. The Coalition of Physical Energy Companies (COPE) recommended that the Commission make clear that section 739 of the Dodd-Frank Act, regarding legal certainty, applies to the proposed regulations so that SD or MSP noncompliance with the rules will not otherwise affect the enforceability of a swap. MFA and the International Energy Credit Association (IECA) also believe that it is imperative that the Commission affirmatively clarify that defects in required regulatory documentation do not render a contract void or voidable by one of the parties or constitute a breach of the swap documentation. IECA added that a party should not have a private right of action with respect to documentation that does not comply with the rules. IECA further requested that the Commission add specific language to proposed § 23.504. The FHLBs made the same argument as IECA, adding that the Commission can enforce the provisions through penalties for SDs and MSPs.

Upon consideration of these comments, the Commission is clarifying that it is not the intent of the rules to provide swap counterparties with a basis for voiding or rescinding a swap transaction based solely on the failure of the parties to document the swap transaction in compliance with the rules. However, the Commission believes it does not have the authority to immunize SDs or MSPs from private rights of action for conduct within the scope of section 22 of the CEA, i.e., for violations of the CEA. In the interest of legal certainty, to avoid disruptions in the swaps market, and to reduce compliance costs, the Commission has determined that it will, in the absence of fraud, consider an SD or MSP to be in compliance with the rules if it has complied in good faith with its policies and procedures reasonably designed to comply with the requirements of each rule.

4. Standing of the ISDA Agreements

Several commenters requested that the Commission clarify the standing under the rules of the ISDA Master Agreement and Credit Support Annex (the ISDA Agreements), which are prevalent in the swaps market. Specifically, ISDA & SIFMA commented that the proposed rules could create uncertainty as to the level of documentation required because the proposed rules require that ''all terms'' governing the swap trading relationship be documented. ISDA & SIFMA thus requested that the Commission acknowledge the general adequacy of the ISDA Agreements for purposes of the rule to enhance legal certainty and market stability. Similarly, COPE argued that many end users have already negotiated existing documentation under the ISDA architecture and thus requested that the Commission make clear that: (1) ISDA Agreements or any substantially similar master agreements satisfy the documentation requirements of the final rules; (2) in accordance with the ISDA Agreements and applicable state law, swaps are binding when made orally; and (3) long-form confirmations that contain all requisite legal terms to establish a binding agreement also satisfy the requirements of the rules. IECA also recommended that the Commission expressly state that the ISDA Agreements satisfy the documentation requirements of the final rules or state how the ISDA Agreements are deficient to eliminate any confusion. Finally, the Coalition for Derivatives End-Users argued that, given that the ISDA Agreements are used by nearly all end users and that such documentation substantially complies with the proposed rules, the Commission should expressly state that the ISDA Agreements satisfy the documentation requirements of the rules.

On the other hand, the Committee on the Investment of Employee Benefit Assets (CIEBA) anticipates that ISDA may initiate a uniform protocol to conform existing ISDA Agreements to the requirements of the rules. In this regard, CIEBA stated that ISDA protocols, which in the past have typically been developed by dealer-dominated ISDA committees, are not form documents that can be revised by the parties. Rather, CIEBA argues, end users may only adopt these protocols on a ''take it or leave it'' basis, which may not be in their best interests. Accordingly, CIEBA recommended that the Commission not, either explicitly or implicitly, require market participants to consent to ISDA protocols in order to comply with the Dodd-Frank Act or the Commission's regulations.

The Commission notes that many comments received with respect to this and other rulemakings stated that swaps are privately negotiated bilateral contracts. Although the Commission recognizes that the ISDA Agreements in their pre-printed form as published by ISDA are capable of compliance with the rules, such agreements are subject to customization by counterparties. In addition, the Commission notes that while the pre-printed form of the ISDA Master Agreement is capable of addressing the requirements of proposed § 23.504(b)(1), it is not possible to determine if the pre-printed form of the ISDA Credit Support Annex will comply with proposed § 23.504(b)(3), because that section requires that the documentation include credit support arrangements that comply with the Commission's rules regarding initial and variation margin and custodial arrangements, which have been proposed but not yet finalized. Further, the Commission does not believe that the standard ISDA Agreements address the swap valuation requirements of § 23.504(b)(4), the orderly liquidation termination provisions of § 23.504(b)(5), or the clearing records required by § 23.504(b)(6). Given the foregoing, the Commission declines to endorse the ISDA Agreements as meeting the requirements of the rules in all instances.

5. Identical Rules Applicable to SDs and MSPs

The proposed regulations did not differentiate between SDs and MSPs, but, rather, applied identical rules to both types of entities. In this regard, BlackRock commented that MSPs are buy-side entities, yet many of the proposed documentation standards are designed to regulate dealing activity. BlackRock believes these requirements should not apply to MSPs because they are unnecessary and will cause both MSPs and the Commission to use resources inefficiently.

The Commission is not modifying the regulations to differentiate between SDs and MSPs. The Commission observes that section 4s(i) of the CEA, as added by the Dodd-Frank Act, does not differentiate between SDs and MSPs. The Commission thus has determined that the intent of section 4s(i) is to apply the same requirements to MSPs and SDs, and the Commission is taking the same approach in the final regulations.

B. Swap Trading Relationship Documentation—§ 23.504

Section 4s(i)(1) requires swap dealers and major swap participants to ''conform with such standards as may be prescribed by the Commission by rule or regulation that relate to timely and accurate confirmation, processing, netting, documentation, and valuation of all swaps.'' Under section 4s(i)(2), the Commission is required to adopt rules ''governing documentation standards for swap dealers and major swap participants.''

OTC derivatives market participants typically have relied on the use of industry standard legal documentation, including master netting agreements, definitions, schedules, and confirmations, to document their swap trading relationships. This industry standard documentation, such as the widely used ISDA Master Agreement and related definitions, schedules, and confirmations specific to particular asset classes, offers a framework for documenting the transactions between counterparties for OTC derivatives products.[7] The standard documentation is designed to set forth the legal, trading, and credit relationship between the parties and to facilitate netting of transactions in the event that parties have to close-out their position with one another or determine credit exposure for margin and collateral management. Notwithstanding the standardization of such documentation, some or all of the terms of the master agreement and other documents are subject to negotiation and modification.

To promote the ''timely and accurate * * * documentation * * * of all swaps'' under section 4s(i)(1) of the CEA, in the Documentation NPRM, the Commission proposed § 23.504(a), which required that swap dealers and major swap participants establish,

[7] The International Swaps and Derivatives Association (ISDA) is a trade association for the OTC derivatives industry (*http://www.isda.org*).

maintain, and enforce written policies and procedures reasonably designed to ensure that each swap dealer or major swap participant and its counterparties have agreed in writing to all of the terms governing their swap trading relationship and have executed all agreements required by proposed § 23.504. The Commission received approximately 31 comment letters in response to the Documentation NPRM and considered each comment in formulating the final rules, as discussed below.

1. Application to Swaps Executed on a SEF or DCM, or Cleared by a DCO

In response to a request for comment in the Documentation NPRM regarding whether proposed § 23.504 should include a safe harbor for swaps entered into on, or subject to the rules of, a board of trade designated as a contract market, ISDA & SIFMA, as well as the American Benefits Counsel and the Committee on Investment of Employee Benefit Assets (jointly, ABC & CIEBA), recommended that the Commission provide such a safe harbor for swaps executed on a swap execution facility (SEF) or designated contract market (DCM). ISDA & SIFMA commented that the safe harbor is especially needed for those transactions where the SD or MSP will not know the identity of its counterparty until just before or after execution. ISDA & SIFMA also urged the Commission to clarify that the term ''swap trading relationship documentation'' is used to describe only bilateral documentation between parties to uncleared swaps. MFA also recommended that the Commission clarify that exchange traded or cleared swaps, which will be subject to standard contract terms, are not subject to the documentation rules. The Working Group commented that the swap trading relationship requirement in § 23.504(a) includes a carve-out for swaps cleared with a DCO, but § 23.504(b)(6) includes express requirements for the swap trading relationship documentation with respect to cleared swaps. Given the apparent contradiction, The Working Group requested that the Commission clarify whether the other requirements of § 23.504 apply to swaps that are intended to be cleared contemporaneously with execution or that are executed on a SEF or DCM.

In response to The Working Group's comment expressing confusion about whether § 23.504 applies to swaps that are cleared by a DCO and to ISDA & SIFMA's comment regarding applicability to cleared swaps, as well as the applicability to pre-existing swaps per the discussion above, the Commission is modifying § 23.504 to clarify the overall applicability of the rule by adding a new paragraph (a)(1) as set forth in the regulatory text of this rule.

This revision clarifies the circumstances under which the rule applies. The proviso in § 23.504(a)(1)(ii) would achieve the rule's goal of avoiding differences between the terms of a swap as carried at the DCO level and at the clearing member level, which could compromise the benefits of clearing. Any such differences raise both customer protection and systemic risk concerns. From a customer protection standpoint, if the terms of the swap at the customer level differ from those at the clearing level, then the customer will not receive the full transparency and liquidity benefits of clearing, and legal and basis risk will be introduced into the customer position. Similarly, from a systemic perspective, any differences could diminish overall price discovery and liquidity and increase uncertainties and unnecessary costs into the insolvency resolution process. The cross reference to § 39.12(b)(6) imports the specific requirements that had been included in proposed § 23.504(b)(6)(v). See below for a more complete discussion of § 23.504(b)(6).

In response to the comment from ISDA & SIFMA, the Commission clarifies that swaps executed anonymously on a SEF or traded on a DCM prior to clearing by a DCO are not subject to the requirements of § 23.504. For those swaps that are not executed anonymously, the swap trading relationship documentation requirements of § 23.504 would apply.

2. Viability of Long-Form Confirmations as Swap Trading Relationship Documentation—§ 23.504(a) & (b)

Proposed § 23.504(b) required that all terms governing the trading relationship between an SD or MSP and its counterparty be documented in writing. Proposed § 23.504(a) required that SDs and MSPs establish policies and procedures reasonably designed to ensure that the required swap trading relationship documentation be executed prior to or contemporaneously with entering into a swap transaction with any counterparty. The Commission notes the industry practice whereby counterparties enter into a ''long-form confirmation'' after execution of transaction, where the long-form confirmation contains both the terms of the transaction and many, if not all, terms usually documented in a master agreement until such time as a complete master agreement is negotiated and executed.

The Office of the Comptroller of the Currency (OCC) commented that the proposed rule may require master agreements between all counterparties even if a ''long-form'' confirmation would sufficiently address legal risks, creating a significant expense and burden for end users. Similarly, IECA commented that long form confirmations that incorporate the terms of a standard master agreement are useful for certain new transaction relationships. In this respect, IECA recommends that § 23.504(b)(1) be modified to make clear that terms can be incorporated by reference.

In response to these comments, the Commission has determined that so long as a ''long-form'' confirmation includes all terms of the trading relationship documented in writing prior to or contemporaneously with the assumption of risk arising from swap transactions, the ''long-form'' confirmation would comply with the rules. However, the Commission is not modifying the rule to permit execution of a long-form confirmation subsequent to the execution of a swap transaction, which the Commission believes results in some period, however short, in which the terms of the trading relationship between the parties are not in written form. In response to the comment of IECA, the rule does not prohibit incorporation of terms by reference. Thus, so long as the terms incorporated by reference are in written form, the documentation would be in compliance with the rule.

3. Confirmation Execution Timing and Swap Trading Relationship Documentation—§ 23.504(a) & (b)(2)

Proposed § 23.504(b)(2) states that swap trading relationship documentation includes transaction confirmations. Proposed § 23.504(a) requires swap trading relationship documentation to be executed prior to or contemporaneously with entering into any swap with a counterparty. However, proposed § 23.501 provides for specific post-execution time periods for confirming swaps. This apparent contradiction was identified by a number of commenters.

In order to reconcile the apparent contradiction, ISDA & SIFMA recommended that confirmations be excluded from swap trading relationship documentation and be treated solely in § 23.501. MFA also recommended that confirmations be treated solely in § 23.501, noting that if forced to choose between quick execution and the negotiation of all terms, the proposed rule's timing requirements might substantially limit end users' ability to engage in proper risk management using tailored swaps. MFA also commented that unless modified, the rule might decrease the number of transactions in the markets, thereby decreasing liquidity and increasing volatility.

IECA noted that many short term transactions are executed orally and often documented by recording, ending before a written confirmation can be completed. IECA also stated that if all confirmations must be in writing, the additional employee time cost for each market participant would be substantial and is not included in the annual cost analysis. The Working Group also commented that in some instances, it may take longer to negotiate a written confirmation for a swap or complete the necessary mid- and back-office processes than the planned duration of the swap at issue. IECA recommended that proposed § 23.504(b)(2) be modified by adding at the end, ''which confirmations need not be in writing.''

MetLife commented that the requirement to document ''all'' terms of a trading relationship is overly burdensome. MetLife believes the documentation subject to regulation should be clarified to mean two sets of documents: A master agreement, credit support arrangement and master confirmation agreement and second, transaction specific confirmations. The confirmations can include any trade specific terms including specific valuation methodologies or inputs not already contained in the master documentation. Differentiation would assist with clarity for policies and procedures and with the audit requirements.

The Coalition for Derivatives End-Users and The Working Group commented that the rule may require pre-trade negotiation and disadvantage the party that is most sensitive to the timing of the swap in such negotiations. The Working Group believes such party may have to accept less than favorable terms in order to execute within its desired time frame, and that the rule would make it very difficult for parties to enter into short-term swaps. The Coalition for Derivatives End-Users point out that end-users often trade by auction and given the low probability of winning, SDs will not want to incur the expense of negotiating documents in advance. The Coalition for Derivatives End-Users also point out that even where established relationships exist, newly formed affiliates may trade based on existing expectations, but without the documents fully executed.

On the other hand, CIEBA commended the Commission for including all terms in swap trading relationship documentation. CIEBA believes this approach will minimize the potential for disputes over swap terms during the confirmation process caused by the introduction of new ''standard'' terms after the swap is executed, which CIEBA stated is a frequent occurrence. CIEBA recommended that the Commission confirm in its final rules that the requirement that documentation ''shall include all terms governing the trading relationship between the swap dealer or major swap participant and its counterparty'' would require all terms to be in writing prior to or at the time of entering into the swap transaction, except for terms such as price, quantity and tenor, that are customarily agreed to contemporaneously with entering into a swap transaction. CIEBA recommended that the rule require these remaining terms to be documented in writing contemporaneously with entering into the swap transaction.

Having considered these comments, the Commission has determined that proposed § 23.504(a) should be clarified with respect to the inclusion of swap confirmations in swap trading relationship documentation. The Commission is therefore modifying the proposed rule to make clear that the timing of confirmations of swap transactions is subject to § 23.501, and that swap trading relationship documentation other than confirmations of swap transactions is required to be executed prior to or contemporaneously with entering into any swap transaction.

The Commission does not, however, agree with commenters suggesting that terms governing a swap or a trading relationship need not be in writing. The Commission recognizes that binding swap contracts may be created orally under applicable law and the rule does not affect parties' ability to enforce such contracts. However, an orderly swap market and the goal of reducing operational risk require that such oral contracts be appropriately documented as soon as possible. In response to the comments of CIEBA, the Commission believes the modifications to the confirmation time periods in § 23.501 discussed below adequately address CIEBA's concerns. Given the foregoing, the Commission is modifying proposed § 23.504(a) to read as set forth in the regulatory text of this rule

4. Swap Trading Relationship Documentation Among Affiliates

The proposed regulations did not include an exemption or different rules for documenting swap trading relationships between affiliates. Shell Energy North America (Shell) commented that an end user trading with an affiliated SD/MSP does not have valuation, trade, and documentation risks that nonaffiliated entities may have, that such transactions only allocate risk within the legal entity, and, accordingly, affiliate transactions should be exempted from the documentation rules.

The Commission is not persuaded that the risk of undocumented (and therefore objectively indiscernible) terms governing swaps is obviated because the trading relationship is with an affiliate. The Commission has regulatory interests in knowing or being able to discover the full extent of a registered SD's or MSP's risk exposure, whether to external or affiliated counterparties, and is not modifying the rule in response to this comment. The Commission observes that to the extent certain risks are not present in affiliate trading relationships, the documentation of the terms related to such risks should be non-controversial and easily accomplished. For example, because affiliates are generally under common control, the documentation of an agreement on valuation methodologies should not require extensive negotiation as it may between non-affiliated counterparties.

5. Use of ''Enforce'' in Proposed § 23.504(a)

Proposed § 23.504(a) required that each SD and MSP establish, maintain, and enforce policies and procedures designed to ensure that prior to or contemporaneously with entering into a swap transaction, it executes swap trading relationship documentation that complies with the rules.

CEIBA questions what is intended by the requirement for SDs and MSPs to ''enforce policies and procedures'' in § 23.504(a). CEIBA believes the use of the term ''enforce'' with respect to SDs' and MSPs' procedures is contrary to the Dodd-Frank Act, because it implies that such procedures have the force of law and can be imposed on counterparties absent mutual agreement. CIEBA recommended that the word ''enforce'' should be deleted.

Having considered this comment, the Commission is modifying the proposed rule by replacing the term ''enforce'' with the term ''follow.'' The intent of the term ''enforce'' in the proposed rule was to require SDs and MSPs to in fact follow the policies and procedures established to meet the requirements of the proposed rule, rather than to enforce its internal policies and procedures against third parties.

6. Payment Obligation Terms—§ 23.504(b)

In the Documentation NPRM, the Commission asked whether the proposed rules should specifically delineate the types of payment obligation terms that must be included in the trading relationship documentation.

CIEBA commented that the Commission need not dictate every term that must appear in swap trading relationship documentation, and that it is important to defined benefit plans to be able to negotiate payment obligation terms in their documentation.

The Commission agrees with CIEBA on this issue and has not modified the rule to further define the types of payment obligation terms required to be specified in swap trading relationship documentation.

7. Additional Requirements for Events of Default and Termination Events

In the Documentation NPRM, the Commission asked whether the requirement for agreement on events of default or termination events should be further defined, such as adding provisions related to cross default.

The Coalition for Derivatives End-Users commented that the ISDA documentation sufficiently addresses these issues and that parties should be allowed to negotiate these terms bilaterally so the Commission need not further define such terms. CIEBA agreed that parties should be allowed to negotiate these terms bilaterally so the Commission need not further define such terms.

The Commission agrees with the commenters on this point and has not modified the rule to further define the types of events of defaults and termination events required to be specified in swap trading relationship documentation.

8. Senior Management Approval of Documentation Policies and Procedures—§ 23.504(a)

Proposed § 23.504(a) required SDs' and MSPs' documentation policies and procedures to be approved in writing by senior management of the SD or MSP.

The Working Group raised a concern that this requirement will be used to the negotiating advantage by SDs and MSPs who will claim that the form of documentation had been approved for regulatory purposes and cannot be changed without a prohibitively lengthy internal approval process. In addition, The Working Group argued that rigid documentation standards that must be approved by senior management could severely limit the flexibility of SDs, ending the ability of end users to obtain customized swaps in a timely manner. The Working Group recommended that the Commission allow current practice to continue where trading managers can authorize deviations from standard trade documentation so long as such amendment does not violate the overarching policies and procedures set by internal management authorized by the governing body.

MFA similarly commented that the senior management approval requirement, together with the cumulative effect of the proscriptive documentation rules, may lead to the institutionalization of the terms favored by SDs and MSPs. As a result, MFA is concerned that SDs and MSPs will compel their customers to accept unfavorable terms or forego time-sensitive market opportunities. Accordingly, MFA recommended that each party should be free to assess requisite approval levels for various kinds of swap activity based on its unique organizational structure.

IECA commented that review by senior management is an unnecessary use of management time. Most SDs and MSPs have risk management policies that provide a framework for elevating issues through levels of management as applicable. By requiring senior management to review too many modifications, many that can be reviewed by lower levels with appropriate expertise, it is likely that senior management may actually miss the major issues that should get attention. Also, IECA argued that the chilling effect of the rule could stifle risk management efforts, innovation, and increase counterparty risk as review processes become too rigid in order to comply with regulatory requirements.

The Commission is not modifying the rule based on these comments. The commenters' concerns are overly broad because the rule requires senior management of SDs and MSPs to approve the ''policies and procedures'' governing swap trading documentation practices, not to approve each agreement, transaction, or modifications thereto. The rule does not prohibit SDs and MSPs from establishing policies and procedures instituting a framework for elevating issues through a hierarchy of management as each sees fit, so long as such framework has been approved in writing by senior management.

9. Dispute Resolution Procedures—§ 23.504(b)(1)

Proposed § 23.504(b)(1) required SDs' and MSP's swap trading relationship documentation to include dispute resolution procedures. In the Documentation NPRM preamble, the Commission asked whether the proposed rules should include specific requirements for dispute resolution (such as time limits), and if so, what requirements are appropriate for all swaps.

ISDA & SIFMA objected that the requirement that the parties agree to dispute resolution procedures is not authorized by the Dodd-Frank Act and that denying parties to a swap access to the judicial system is not a measure that should be taken lightly or without Congressional consideration. Similarly, IECA believes the proposed regulations for dispute resolution are too specific and could violate separation of powers under the Constitution.

On the other hand, CIEBA responded that the rules should not include specific requirements, with the exception of requiring the availability of independent valuation agents that are agreed upon by the parties. CIEBA recommended that the Commission propose only a set of fair and even-handed principles for resolving disputes.

In response to these comments, the Commission is modifying the proposed rule to delete the term ''procedures'' from the requirement that swap trading relationship documentation include ''terms addressing * * * dispute resolution procedures.'' The Commission notes that the rule as proposed was not intended to require SDs and MSPs to agree with their counterparties on specific procedures to be followed in the event of a dispute, but rather to require that dispute resolution be addressed in a manner agreeable to both parties, whether it be in the form of specific procedures or a general statement that disputes will be resolved in accordance with applicable law. The Commission believes that some form of agreement on the handling of disputes between SDs, MSPs, and their counterparties will be essential to ensuring the orderly operation of the swaps market.

10. Documentation of Credit Support Arrangements—§ 23.504(b)(3)

Proposed § 23.504(b)(3) required that the swap trading relationship documentation include certain specified details of the credit support arrangements of the parties.

Better Markets recommended that the Commission revise the proposed rule to require documentation of the terms under which credit may be extended to a counterparty by a registrant in the form of forbearance from funding of margin and the cost of such credit extension, arguing that such credit extension and the cost thereof, which is embedded in the price of a swap, seriously impairs the transparency of the market by concealing the true price of a swap divorced from the cost of credit.

Michael Greenberger commented that leaving terms and rules regarding credit extension and transactional fees to subjective desires of market participants will be counterproductive. Mr. Greenberger supports the comment letter by Better Markets, Inc., which urges the Commission to propose definitive rules requiring documentation of credit extension and transactional fees.

COPE asked the Commission to clarify that the rule requires trading documentation to include any applicable margin provisions and related haircuts, but does not require margining and haircuts unless agreed by the parties. IECA echoed the COPE comment, stating that the proposed rule is unclear whether parties can enter into a swap that requires no margin, as is contemplated in the Dodd Frank Act.

CIEBA commented that proposed § 23.504(b)(3) should be clarified by adding the words ''if any'' to the end of each of subsections (i) through (iv) to make clear that end users are not required to post initial margin or allow rehypothecation.

Having considered these comments, the Commission is of the view that the proposed rule was not intended to require margin or related terms where such are not required pursuant to other Commission regulations or the applicable regulations adopted by prudential regulators. The proposed rule was intended to require written documentation of any credit support arrangement, whether that be a guarantee, security agreement, a margining agreement, or other collateral arrangement, but only to require written documentation of margin terms if margin requirements are imposed by Commission regulations, the regulations of prudential regulators, or are otherwise agreed between SDs, MSPs, and their counterparties. Thus, in response to commenters' requests for clarification, the Commission is modifying the proposed rule as recommended by CIEBA by adding ''if any'' at the end of each of subsections (i) through (iv) of § 23.504(b)(3). The Commission expects that other forms of credit support arrangements will be documented in accordance with the rule as well.

However, the Commission is not revising the rule to enumerate the terms of any extension of credit that are required to be included in the documentation, as recommended by Better Markets. The Commission believes that the rule, as proposed and as adopted by this release, already requires documentation of initial and variation margin requirements, which necessarily will entail documentation of any extension of credit, i.e., the documentation will reflect whether margining is subject to any credit extension threshold. Thus, to the extent applicable, credit support arrangements must include, at a minimum, the maximum amount of credit to be extended, the method for determining how much credit has been extended, and any term of the facility and early call rights. During negotiations regarding credit support arrangements, counterparties would be well served to address issues related to the embedded cost of credit. The Commission also observes that transactional fees are required to be disclosed under § 23.431 of the Business Conduct Standards for SDs and MSPs Dealing with Counterparties.[8]

11. Legal Enforceability of Netting and Collateral Arrangements—§ 23.504

The proposed regulations did not require SDs and MSPs to document the legal enforceability of netting and collateral arrangements in the swap trading relationship documentation.

In this regard, Volvo Financial Services Europe (Volvo) recommended that the Commission adopt a rule that states clearly that credit support arrangements should include legal opinions (updated annually) verifying the perfection of security interests in collateral supporting net exposures. Volvo argued that lack of legal certainty contributed to losses in the 2008 financial crisis where counterparties discovered that un-perfected security interests resulted in the unenforceability of pledged collateral. Specifically, Volvo recommended that the Commission revise the proposed rules to require: (i) Mandatory collateralization, (ii) robust legal opinions (updated annually) on enforceability of collateral arrangements, (iii) zero risk weighting if robust legal opinions are obtained, and (iv) regular collateral audits by the Commission to ensure that market participants perform the perfection formalities of security interests.

Although the Commission agrees with the commenter that SDs and MSPs should support their collateral arrangements with all necessary legal analysis, the Commission has not made any changes to the proposed rule based on this comment because the Commission believes (1) Volvo's concerns regarding margining of uncleared swaps are addressed in the Commission's proposed margin rules, or the prudential regulators' proposed margin rules, as applicable, and (2) Volvo's concerns regarding the legal enforceability of collateral arrangements is addressed in risk management rules adopted by the Commission in February, 2012.[9]

12. Valuation Methodology Requirement—§ 23.504(b)(4)

Proposed § 23.504(b)(4) required that the swap trading relationship documentation of each SD and MSP with their counterparties include an agreement in writing on the methods, procedures, rules, and inputs for determining the value of each swap at any time from execution to the termination, maturity, or expiration of such swap.

a. Comments Received

Twenty of the comment letters received by the Commission addressed the proposed valuation requirement in § 23.504(b)(4). Many of those comments raised similar concerns about the proposal, as summarized thematically, below:

The Working Group, ISDA & SIFMA, FSR, White & Case, Morgan Stanley, COPE, MFA, IECA, FHLBs, Hess Energy Trading Company, LLC (Hess), Riverside Risk Advisors LLC, and Edison Electric Institute (EEI) commented that valuation disputes provide valuable information to both market participants and regulators about pricing dislocations and associated credit risks and a static, rigid valuation methodology necessarily produces values that become increasingly outdated over time and could impede

[8] *See* Subpart H of Part 23 of the Commission's Regulations, Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 FR 9734, 9824 (Feb. 17, 2012). In addition, to the extent that any cost of credit may be embedded in the price of a swap, the Commission believes that the disclosure of the mid-market mark, which must be disclosed when an SD or MSP discloses the price of a swap, will facilitate greater transparency concerning the embedded cost of credit. *Id.* at 9765–66 (discussing new § 23.431(a)(3)(i)).

[9] *See* 17 CFR 23.600(c)(4)(v)(A) requiring SDs and MSPs to establish policies and procedures to monitor and manage legal risk, including policies and procedures that take into account determinations that transactions and netting arrangements entered into have a sound legal basis. 77 FR 20128, 20206 (Apr. 3, 2012).

the transmission of this important risk information.

The Working Group, ISDA & SIFMA, FSR, Markit, Freddie Mac, COPE, MFA, FHLBs, CIEBA, EEI, and the Coalition of Derivatives End Users commented that requiring agreement on valuation methodologies and set alternative methods will materially increase the pre-execution negotiating burden without an offsetting benefit and agreement on models for complex swaps would require negotiations that could take sophisticated professionals months to complete, if such could be completed at all.

The Working Group, FSR, OCC, and Markit commented that it is impossible to state valuation methodologies with the required specificity without disclosing proprietary information about the parties' internal models.

OCC and Hess commented that requiring agreement on valuation methodologies may discourage development of more refined, dynamic swap valuation models, which would lead to use of less sophisticated or vanilla models that are less accurate than their proprietary counterparts.

ISDA & SIFMA and IECA commented that agreeing on a methodology that could survive the loss of any input to the valuation is wholly unworkable, will diminish standardization as parties negotiate bespoke approaches to valuation, and will undermine legal certainty if the valuation methodology is determined not to be adaptable to all circumstances.

COPE, FHLBs, MFA, EEI, and Markit commented that there is no business need for swap-by-swap valuation formulas because valuation of exposures with counterparties is usually conducted on a portfolio basis and documented in a master agreement, and that agreement on swap-by-swap valuation formulas also is likely to disrupt trading.

Several commenters also recommended alternative approaches to the valuation requirement. The Working Group, Morgan Stanley, MFA, IECA, FHLBs, CIEBA, and MetLife suggested that the focus of the rule should be on the valuation dispute resolution process rather than valuation methodologies that include fallback alternatives and other static terms. MetLife specifically recommended that the Commission establish ''mandatory dispute resolution guidelines'' that include a requirement for a third party arbiter after a set period of time.

With respect to valuation methodologies, CIEBA and Chris Barnard recommended that the rule require SDs to value swaps on the basis of transparent models that can be replicated by their counterparty. The Working Group requested that the Commission clarify that parties are permitted to use different valuation methodologies under different circumstances (i.e., mid-market valuation for collateral purposes and replacement cost valuation for terminations). Markit and MFA requested that the Commission clarify that parties may rely on a more general set of inputs, models, and fallbacks for valuation purposes, rather than the exhaustive fallbacks required by the rule. White & Case and IECA recommended that the Commission permit parties to change the valuation method and inputs as the market changes over time. Freddie Mac suggested that the rule should provide that the valuation methodology requirement can be satisfied by executing industry standard documentation that provides for a commercially reasonable valuation methodology. The Coalition of Derivatives End Users, IECA, and Chris Barnard recommended that proprietary inputs be allowed under the rule.

More generally, FSR recommended that the Commission withdraw the proposed valuation requirement until the Commission has the time to conduct a thorough study, including a comprehensive cost-benefit analysis, whereas Markit recommended that the rule be modified to explicitly allow parties to comply with the rule by agreeing that an independent third party may provide any or all of the elements required to agree upon the valuation of swaps. The Coalition of Derivatives End Users recommended that the Commission change the rule to require SDs and MSPs to provide commercially reasonable information to substantiate its valuations upon an end user's request, instead of requiring extensive pre-trade documentation of valuation methodology.

The Working Group recommended that the Commission modify the rule to provide that the valuation requirements for cleared swaps or swaps executed on a trading facility should be satisfied by referencing the price provided by the relevant DCO or facility, while Markit recommended that the Commission clarify that neither prices of recently executed transactions or any other single pricing input should be regarded as preferable inputs for the valuation of swaps and explicitly permit parties to use pricing sources other than DCOs, even for cleared swaps.

A number of commenters supported the rule. Chris Barnard strongly supported the requirement that the agreed methods, procedures, rules and inputs constitute a ''complete and independently verifiable methodology for valuing each swap entered into between the parties,'' and that the methodology must include alternatives ''in the event that one or more inputs to the methodology become unavailable or fail.'' Mr. Barnard also supported the requirement for SDs and MSPs to ''resolve a dispute over the valuation of a swap within one business day.'' Michael Greenberger generally supported the valuation methodology rule to promote transparency and financial integrity. MetLife agreed with the proposal that parties should determine upfront what the valuation methodologies will be to help mitigate disputes, but believes that disputes will not be eliminated by the rule.

CIEBA commended the Commission for requiring objective and specific valuation mechanisms in swaps documentation and believes that this requirement will limit the potential for valuation disputes. However, CIEBA believes requiring objective and specific valuation mechanisms is not enough. In addition to requiring SDs to value swaps using transparent models that can be replicated by their counterparties, CIEBA recommended that the Commission require the mechanisms or procedures by which disputes are resolved to be fair and even-handed and should not override existing contractual protections negotiated by the parties.

b. Commission Response

Having considered these comments, the Commission is modifying and clarifying the proposal in a number of ways. First, in response to concerns from non-financial entities regarding the cost and the challenges of pre-execution negotiation, the Commission is modifying the rule to require valuation documentation only at the request of non-financial entities. In other words, non-financial entities will have the ability, but not the obligation, to enter into negotiations on valuation with their SD or MSP counterparties. As discussed below, the rule will continue to apply to SDs, MSPs, and financial entities.

While the Commission agrees with commenters regarding the importance of using transparent models that can be replicated, the Commission recognizes concerns about protecting proprietary information used in internal valuation models. Thus, the Commission has modified the rule to clarify the requirement that the agreement on valuation use objective criteria, such as recently-executed transactions and valuations provided by independent third parties. In this regard, the

Commission agrees with The Working Group that the valuation requirements for cleared swaps or swaps executed on a trading facility would be satisfied by referencing the price provided by the relevant DCO, SEF, or DCM.

Additionally, the Commission confirms commenters' understanding that proprietary models may be used for purposes of valuation, provided that both parties agree to the use of one party's confidential, proprietary model. An agreement by the parties to use one party's confidential, proprietary model is sufficient to satisfy the requirements of § 23.504(b)(4)(i), including the requirement that the parties agree on the methods, procedures, rules and inputs for determining the value of each swap. On the other end of the spectrum from simply agreeing to use one party's model, counterparties may, if they choose, elect to negotiate precisely which model and inputs will govern the valuation of their swaps. Counterparties would be free to elect either of these options or many other possibilities under the terms of § 23.504(b)(4) so long as the resulting valuations are sufficient to comply with the margin requirements under section 4s(e) of the CEA and the risk management requirements under section 4s(j) of the CEA, and there is a dispute resolution process in place or a viable alternative method for determining the value of the swap. Moreover, the Commission is modifying proposed § 23.504(b)(4)(iii) to clarify that confidential, proprietary model information is protected under the rule.

To address concerns that the use of the phrase ''methods, procedures, rules, and inputs'' could be interpreted as requiring agreement on the precise model and all inputs for valuing a swap, the Commission is modifying the rule text to require that parties agree on ''the process, including methods, procedures, rules, and inputs for determining the value of each swap.''

Importantly, the Commission is responding to commenters' concerns about the requirement that the valuation documentation be stated with sufficient specificity to allow the SD, MSP, the Commission, and any prudential regulator to value the swap ''independently in a substantially comparable manner.'' Commenters viewed this standard as problematic because they read it to require disclosure of proprietary information or to prevent the updating or revising of models, among other things. Accordingly, the Commission has determined to remove this provision from the final rule. So long as the valuation documentation is stated with sufficient specificity to determine the value of the swap for purposes of complying with the requirements of the rule—namely, the margin and risk management requirements under section 4s of the CEA and Part 23 of Commission regulations—the requirements of § 23.504(b)(4)(i) would be met.

Under this approach, parties may rely on a general set of methods, inputs, models, and fallbacks for valuation purposes so long as the process is sufficient to determine the value of a swap. In response to concerns that the proposal would require a methodology that would be static or rigid over time, the Commission is further modifying the rule to make explicitly clear that the parties may agree on a process, including methods or procedures for modifying or amending the valuation process as circumstances require and as the market changes over time.[10]

The Commission does not disagree with commenters that differences in valuations can provide valuable information to both market participants and regulators about pricing dislocations and associated credit risks. Moreover, the objective is not to produce values that become increasingly outdated over time. Rather, the Commission believes that by requiring agreement between counterparties on the methods and inputs for valuation of each swap, § 23.504(b)(4) will assist SDs and MSPs and their counterparties to arrive at valuations necessary for margining and internal risk management, and to resolve valuation disputes in a timely manner, thereby reducing risk.

Agreement between SDs, MSPs, and their financial entity counterparties on the proper daily valuation of the swaps in their swap portfolio is an essential component of the Commission's margin proposal. Under proposed § 23.151, non-bank SDs and MSPs must document the process by which they will arrive at a valuation for each swap for the purpose of collecting initial and variation margin in compliance with the requirements of § 23.504. All non-bank SDs and MSPs must collect variation margin from their non-bank SD, MSP, and financial entity counterparties for uncleared swaps on a daily basis. Variation margin requires a daily valuation for each swap. For swaps between non-bank SDs and MSPs and non-financial entities, no margin is required to be exchanged under Commission regulation, but the non-bank SDs and MSPs must calculate a hypothetical variation margin requirement for each uncleared swap for risk management purposes under proposed § 23.154(b)(6).[11] The daily valuation agreed to by the counterparties is necessary for compliance with the margin requirements proposed by the Commission and the prudential regulators under section 4s(e) of the CEA.

In addition to the fact that arriving at a daily valuation is one of the building blocks for the margin rules, timely and accurate valuations are essential for the risk management of swaps by SDs and MSPs. Under § 23.600(c)(4)(i), the Commission required that SDs and MSPs have risk management policies and procedures that take into account the daily measurement of market exposure, along with timely and reliable valuation data. The valuation documentation requirements under § 23.504(b) and the risk management provisions of § 23.600 work together to ensure that SDs and MSPs have the most accurate and reliable valuation data available for internal risk management and for collateralization of risk exposures with counterparties. This is not to say that valuation disputes can be prevented entirely or that these disputes do not, at times, offer useful insight into the marketplace. Indeed, risk management personnel and management within the SD or MSP should pay particular attention to different valuations for the same swap originating within their organization or from outside the entity. For these purposes, the Commission expects that valuation disputes that are not resolved in accordance with these rules be elevated to senior management in the firm.[12] However, the final rule reflects the recognition that accurate and

[10] To the extent that one or both parties foresee that the valuation method or inputs agreed for a swap or a class or category of swaps will likely require modification, parties would be well-served to agree in advance in their swap trading relationship documentation on an appropriate arrangement for accommodating such modifications.

[11] SDs and MSPs that are banks are subject to the requirements of section 4s(i). In addition, under the prudential regulators' margin proposal, SDs and MSPs that are banks would be required to have documentation in place that specifies the ''(1) [t]he methods, procedures, rules, and inputs for determining the value of each swap * * * for purposes of calculating variation margin requirements; and (2) [t]he procedures by which any disputes concerning the valuation of swaps * * * or the valuation of assets collected or posted as initial margin or variation margin, may be resolved.'' Margin and Capital Requirements for Covered Swap Entities, 76 FR 27564, 27589 (May 11, 2011).

[12] Under § 23.600(c)(1)(1)(iii), the risk management program requires SDs and MSPs to have policies and procedures for detecting breaches of risk tolerance limits set by an SD or MSP, and alerting supervisors within the risk management unit and senior management, as appropriate.

reliable valuations are the foundation of margining and risk management.

The Commission also agrees with commenters that the trading documentation should be permitted to focus on the valuation dispute resolution process rather than exclusively on fallback methodologies, and has further modified the rule to allow for either fallback methodologies or agreement on a dispute resolution process, but does not think it necessary or desirable to specify a standard dispute resolution process at this time, as requested by MetLife.

Lastly, the Commission wishes to distinguish its use of the terms ''valuation'' under section 4s(i) of the CEA and ''daily mark'' under section 4s(h). In its final rules for Business Conduct Standards for SDs and MSPs with Counterparties, the Commission explained that the daily mark for uncleared swaps represented the mid-market mark of a swap provided by an SD or MSP to its counterparty.[13] The mid-market mark of the swap represents an objective value that provides counterparties with a baseline to assess swap valuations for other purposes.[14] By contrast, in § 23.504(b)(4), the Commission is requiring that SDs, MSPs, and their counterparties agree to a process for determining the current market value or net present value of a swap for purposes of collateralizing the risk posed by the swap and internal risk management. The critical difference being the agreement of both counterparties to the process for determining the value of a swap, rather than just the SD's or MSP's calculation of the mid-market value of the swap.

13. Application to Cleared Swaps—§ 23.504(b)(6)

Proposed § 23.504(b)(6) required the swap trading relationship documentation of SDs and MSPs to include certain items upon acceptance of a swap for clearing by a DCO, including documentation of each counterparty's clearing member, the date and time the swap was cleared, that the swap conforms to the terms of the DCO's templates, and that the clearing member's books reflect the terms of the swap at the DCO. The proposed regulation also required the documentation to contain a statement that the original swap is extinguished and replaced by a swap subject to the rules of the DCO.

ISDA & SIFMA urged the Commission to clarify that the term ''swap trading relationship documentation'' is used to describe only bilateral documentation between parties to uncleared swaps. ISDA & SIFMA recommend that the Commission not finalize § 23.504(b)(6) because ISDA & SIFMA (1) Saw no need to record the identity of its counterparty's clearing member; (2) recommended that the obligation to provide notice of the date and time of clearing and the identity of the DCO is deemed satisfied when the counterparty receives a clearing report from the DCO; (3) objected to notifying the counterparty of the SD's or MSP's clearing member as that information may be sensitive and is not material to the counterparty; and (4) saw no need to state facts about the counterparty's cleared swap in trading relationship documentation.

CME commented that existing clearing houses use an agency model with FCMs acting as the agent and guarantor for customers, providing numerous benefits. To preserve the agency structure, CME requested that § 23.504(b)(6)(v)(B) be changed to read ''The original swap is replaced by equal and opposite swaps with the derivatives clearing organization.''

CME further commented that under the rule the anonymity of the customer of the clearing member on the other side of the trade to the clearing member will be lost. CME does not believe the anonymity needs to be lost to serve the purposes of the documentation rules.

MFA commented that one of the benefits of central clearing is anonymity, such that once parties submit a swap for central clearing, it need not retain or know any information about the counterparty. MFA recommended that the final rule not require any identifying information about the parties and their firms.

The Commission has considered the commenters' recommendation to delete the clearing record provisions of § 23.504(b)(6)(iii) and (iv) and agrees that there is no need to include in the trading documentation a record of the names of the clearing members for the SD, MSP, or counterparty. The Commission notes that the new applicability provision added to § 23.504(a)(1) provides that the swap trading relationship documentation rule does not apply to swaps executed anonymously on a DCM or SEF, but believes that anonymity may also be important in the execution of swaps executed off-facility, such as in the execution of block trades with asset managers where allocation may take place following acceptance of the block trade for clearing by a DCO. Once a swap is accepted for clearing, the identity of a counterparty's clearing member is no longer relevant and requiring such a record has the possibility to undermine the anonymity of central clearing. Therefore, those provisions have been deleted from the final rule. Similarly, § 23.504(b)(6)(i) and (ii) have been removed because those records will be captured under the SD and MSP recordkeeping requirement, § 23.201(a)(3), and the Commission believes those records are sufficient.

With regard to proposed § 23.504(b)(6)(v), the Commission has retained but streamlined the provision, as recommended by ISDA & SIFMA and CME, to include only the text in § 23.504(b)(6) set forth in the regulatory text of this rule.

The Commission continues to believe that swap trading relationship documentation should make clear the effects of clearing a trade with a DCO; i.e., that the original swap is extinguished and replaced with a swap facing the DCO that conforms to the terms established under the DCO's rules. The Commission has determined that an orderly swap market requires this notice to clarify that the terms of the swap under a DCO's rules are definitive and trump any contradictory terms that may have been included in the swap as executed between an SD or MSP and its counterparty.[15]

14. Annual Audit of 5 Percent of Swap Trading Relationship Documentation—§ 23.504(c)

Proposed § 23.504(c) required that SDs and MSPs, at least once during each calendar year, have an independent internal or external auditor examine no less than 5 percent of the swap trading relationship documentation created during the previous twelve month period to ensure compliance with Commission regulations and the written policies and procedures established pursuant to § 23.504.

In response to the proposal, ISDA & SIFMA, FSR, and Hess urged the Commission to adopt a principles-based approach to the audit requirement and only require SDs and MSPs to conduct periodic audits sufficient to identify material weaknesses in their documentation policies and procedures.

[13] *See* 77 FR 9734, 9767–68 (Feb. 17, 2012); *see also* Swap Data Recordkeeping and Reporting Requirements, 77 FR 2136, (Jan. 13, 2012) (defining ''valuation data'' by reference to section 4s(h)(3)(B)(iii) of the CEA and § 23.431.

[14] *See* § 23.431(d). SDs and MSPs must provide a daily mark for uncleared swaps that is the mid-market mark of the swap which does not include amounts for profit, credit reserve, hedging, funding, liquidity, or any other costs or adjustments.

[15] This provision corresponds to § 39.12(b)(6), which establishes parallel requirements for DCOs clearing swaps. Both proposals have been modified in a similar manner for the final rules.

Similarly, IECA recommended that the Commission require an audit of a random sample, rather than 5 percent, which IECA found too costly. Commenting on a different aspect of the proposal, Michael Greenberger thought that allowing internal audits, as opposed to external, could undermine transparency and accountability.

In response to commenters and as a cost-saving measure, the Commission is modifying the proposed rule in accordance with the alternative recommended by ISDA & SIFMA, FSR, and Hess by removing the 5 percent audit requirement and replacing it with a more general requirement that SDs and MSPs conduct periodic audits sufficient to identify material weaknesses in their documentation policies and procedures. With respect to Mr. Greenberger's comment, the Commission continues to believe that internal auditors are sufficient as a record of the results of each audit will be retained and can be reviewed by Commission staff during examinations of the SD or MSP or investigations by Commission enforcement staff.

15. Dispute Reporting—§ 23.504(e)

The proposed regulations required SDs and MSPs to notify the Commission and any applicable prudential regulator or the SEC of any swap valuation dispute not resolved within one business day, if the dispute is with a counterparty that is an SD or MSP, or within five business days if the dispute is with any other counterparty.

In response to the proposal, ISDA & SIFMA recommended that the Commission should limit reporting to material disputes at the portfolio level, urging the Commission to accept the materiality thresholds for reporting established by the OTC Derivatives Supervisors' Group process, which require reporting of disputes above a certain dollar threshold and only after such disputes have had a proper time to mature. ISDA & SIFMA argued that rule as proposed will be overly burdensome and the over-reporting will cause substantial informational ''noise.''

MFA strongly agreed that the Commission should adopt rules related to valuation disputes and their timely resolution, but questioned whether regulators need notice of every unresolved dispute regardless of their materiality from a systemic risk or regulatory perspective. MFA also commented that the proposed dispute resolution period of one business day for unresolved disputes among SDs and MSPs is too short, arguing that valuation disputes may require discussion and negotiation by and among several levels of management and many different operational teams at an SD or MSP. MFA thus recommended that the Commission provide for five business days to resolve a valuation dispute in an account before they must give regulators notice and only require notice to regulators where the amount in dispute exceeds either (a) $100 million, or (b) both 10 percent of the higher of the parties' valuation and $50 million. In addition, MFA strongly believes that any notices of disputes should be treated confidentially by regulators, and not be subject to public access.

IECA argued that the proposed rule should be removed because it creates an unlevel playing field by creating pressure on a party that wants to avoid reporting to concede in any dispute.

MetLife agreed that the Commission should establish strict timelines for reporting disputes, but argued that the periods proposed are too short to allow parties to resolve disputes on their own. MetLife recommended that disputes between SD/MSPs should be given 3 days before reporting is required and be subject to a materiality condition of 10 percent of the calculated valuation of the swap in dispute.

Hess recommended that the Commission limit reporting to material disputes dependent on the risk the dispute may pose to the financial system taking into account the size of the dispute relative to the size of the trade, the collateral involved, and the size of the parties involved.

For the reasons submitted by these commenters, the Commission has determined that only material swap valuation disputes should be reported to the Commission, any applicable prudential regulator, and the SEC (with regard to swaps defined in section 1a(47)(A)(v) of the Act). Thus, the Commission is modifying the rule to provide that SDs and MSPs shall provide notice of any swap valuation dispute in excess of $20,000,000 (or its equivalent in any other currency).[16] The Commission has determined that the $20,000,000 materiality threshold for reporting is sufficiently high to eliminate unnecessary ''noise'' from over-reporting, but not so high as to eliminate reporting that the Commission may find of regulatory value, such as a large number of relatively small disputes that in aggregate could provide the Commission with information regarding a widespread market disruption.

In addition, the Commission is modifying the requirement for SDs and MSPs to report unresolved valuation disputes within one business day if the dispute is with a counterparty that is a SD or MSP. SDs and MSPs now will be required to report unresolved valuation disputes within three business days. For disputes with counterparties that are not SDs or MSPs, the rule is unchanged from the proposal, requiring that unresolved disputes be reported within five business days.

The Commission has also determined that the reporting requirement of the rule better fits with the resolution requirement under the portfolio reconciliation rule at § 23.502 and has renumbered the rule as § 23.502(c). The Commission notes that the reporting requirement under the rule as adopted is distinct from the swap valuation methodology requirement under § 23.504(b)(4), discussed above, and the time period requirement for SDs and MSPs to resolve swap valuation disputes in § 23.502, discussed below.

16. Orderly Liquidation Termination—§ 23.504(b)(5)

Proposed § 23.504(b)(5) required SDs and MSPs to include in their swap trading relationship documentation an agreement with their counterparties that, in the event a counterparty is a covered financial company (as defined in section 201(a)(8) of the Dodd-Frank Act) or an insured depository institution (as defined in 12 U.S.C. 1813) for which the Federal Deposit Insurance Corporation (FDIC) has been appointed as a receiver (the ''covered party''), the non-covered party is subject to certain limitations specified by law following the appointment of the FDIC as receiver of the covered party and the non-covered party acknowledges that the FDIC may take certain actions with respect to the transactions governed by such documentation.

In response to the proposal, ISDA & SIFMA and FSR argued that because the rule language is not identical to section 210 of the Dodd-Frank Act, the proposed rule requiring an agreement between counterparties in swap trading relationship documentation could inadvertently expand FDIC powers beyond limits set by Congress by creating a discrepancy between the FDIC's actual powers under Title II of the Dodd-Frank Act and the treatment consented to by the parties. ISDA & SIFMA believe that any discrepancy could operate to strip parties of legal

[16] Compare with ESMA Draft Technical Standards, Article 4 RM, subsection 2, (stating that ''counterparties shall report to the competent authority * * * any disputes between counterparties relating to an OTC derivative contract, its valuation or the exchange of collateral for an amount or a value higher than EUR 15 million and outstanding for at least 15 business days.'')

rights to challenge their treatment under Title II of the Dodd-Frank Act. This, in turn, could raise questions about whether the rule is a proper exercise of the Commission's rulemaking authority. ISDA & SIFMA recommended that the Commission revise the rule to only require a notice of the relevant provisions of Title II.

CIEBA also noted that the proposed language is similar to, but not the same as, the statutory text in the Dodd-Frank Act and the FDIA, and could harm its constituents. By substituting terms and apprising parties of some, but not all, of their rights, the proposed rule increases the risk of disputes and creates uncertainty as to what will be required to comply with both the statute and the regulatory regime. As an example, CIEBA cited section 210(c)(9)(A)(i) of the Dodd-Frank Act, which states that, in the context of orderly liquidation, the FDIC may elect to ''transfer to one financial institution, (i) all qualified financial contracts * * * or (ii) transfer none of the qualified financial contracts, claims, property or other credit enhancement referred to in clause (i) (with respect to such person and any affiliate of such person).'' In contrast to this statutory language, the proposed rule uses ''may,'' which suggests that the FDIC has the discretion to transfer less than all qualified financial contracts in contrast to its statutory requirement to transfer all or none. CIEBA also notes that the proposed regulation would remain effective even if the statutory provision it implements is repealed or amended. This could result in parties being forced to waive rights that protect their financial interest in times of market turmoil. In the alternative, CIEBA recommended that the Commission require the documentation to include a written statement in which the counterparties agree that they will comply with the requirements, if any, of section 210(c)(10)(B) of the Dodd-Frank Act and section 11(e)(10)(B) of the Federal Deposit Insurance Act, or instead, require an SD or MSP to include a statement thereof in its risk disclosure documents. At the least, CIEBA requests that the Commission add an additional section to proposed § 23.504(b)(5) to reflect a counterparty's right to suspend payments to the covered party for the period of the stay, as provided in section 210(c)(8)(F)(ii) of the Dodd-Frank Act.

EEI & NRECA also objected to the proposed rule, arguing that a statutory provision intended to encourage cooperation between the FDIC and the Commission does not provide the Commission with authority to unilaterally establish new jurisdiction for itself and that the Commission should allow the FDIC to take the lead as contemplated by Title II of the Dodd-Frank Act. EEI & NRECA stated that energy end users would be particularly harmed by the proposed rule because swaps would be covered by the rule, but not physical transactions, causing energy end users to separately collateralize swaps and physical transactions, eliminating their ability to cost-effectively hedge commercial risks using swaps.

The FHLBs acknowledged the potential applicability of the orderly liquidation provisions of the Dodd-Frank Act, but also objected to the inclusion of the provisions in the swap documentation as the provisions would apply notwithstanding such inclusion and doing so could create legal uncertainty since other liquidation regimes are not listed in the documents.

MetLife objected specifically to the requirement to include consent to FDIC liquidation, arguing that such consent may foreclose a party's right to appeal or challenge the FDIC's actions. MetLife also raised concerns that blanket consent could place the remaining party in a position where it has unwanted excessive credit exposure to the new counterparty, resulting in violation of state law requirements with respect to credit ratings and other credit quality requirements. MetLife requested that the section be removed or that a provision be added to allow a party to object to any proposed transfer.

Hess argued that the provision is not appropriate because the large majority of SDs and MSPs will likely not be ''covered financial companies'' and as of now, the actual application of Title II is unclear. Hess recommended that the rule only require SDs and MSPs to provide notice of the possibility of FDIC liquidation.

Chris Barnard commented that the authority of the FDIC is statutory in nature, and so would automatically apply to the relevant swaps, overriding any current practice. Given this point, Mr. Barnard believes the provision is redundant.

In contrast to the foregoing, Better Markets fully supported the proposed rule, stating that the proposed rule represents a clarification of a fundamental feature of swaps; the consequences of a default by an SD or MSP. Better Markets stated that a basic premise of derivatives in bankruptcy is the exemption from the automatic stay such that the non-defaulting party may immediately terminate and apply collateral post insolvency. Better Markets agreed that the proposed rule documents an important exception to that right newly created in the Dodd-Frank Act. Better Markets believes that clarity, both at inception of a swap and at default, is the foundation of the Dodd-Frank Act, because lack of clarity contributed heavily to the financial crisis and caused much harm.

The Commission has carefully considered each of the comments received on the proposal. At the outset, the Commission believes that, in the context of the proposed rules, it is not possible to track the statutory language of Title II of the Dodd-Frank Act any more closely. Given the imperfectability of reproducing such statutory language and the context in which it appears in the rule, the Commission is sensitive to commenters' concerns that the rule could have a different legal effect in application as compared to application of the statutory language. The Commission is also aware that the statutory provisions will apply to covered financial companies and insured depository institutions placed into FDIC receivership even if not included in this rule. Therefore, the Commission has determined that the best course is to revise the proposed rule to require that swap trading relationship documentation contain only a notice as to whether the SD or MSP or its counterparty is an insured depository institution or financial company and that the orderly liquidation provisions of the Dodd-Frank Act and the FDIA may limit the rights of the parties under their trading relationship documentation in the event either party is deemed a ''covered financial company'' or is otherwise subject to having the FDIC appointed as a receiver.

C. End User Exception Documentation—§ 23.505

1. Overlap With Proposed § 39.6

The proposed regulation required SDs and MSPs, when transacting with market participants claiming the exception to clearing under section 2(h)(7) of the CEA, to obtain documentation sufficient to provide a reasonable basis on which to believe that its counterparty meets the statutory conditions required for the exception. Various requirements for the documentation were listed in the proposed rule.

In response to the proposal, The Working Group and Encana Marketing (USA), Inc. (Encana) argued that because proposed § 39.6 would require SDs and MSPs to collect and report the information relevant to the section 2(h)(7) clearing exception, the proposed rule should be revised to impose no documentation obligations with regard to this exception. Encana also commented that in the alternative, § 23.505 should only require that SDs and MSPs obtain ''documentation'' that the counterparty qualifies as an end user in the transaction documents, but did not specify what form such documentation should take. COPE also commented that the proposed rule is burdensome and redundant to proposed § 39.6 and believes that the attestation required by proposed § 39.6 should be sufficient.

Michael Greenberger, on the other hand, believes a check-the-box approach is insufficient, and recommended enhanced reporting requirements ensuring that the calculation methodology and the effectiveness of the hedged position are well documented. Better Markets also recommended enhanced reporting, suggesting that end users report their hedging transactions to SDRs as provided in proposed § 39.6. Requiring end users to provide information for each transaction to SDs and MSPs separately is overly burdensome whereas direct reporting to SDRs would amount to only a slight change from current prudent practice at many end users.

Having considered these comments, the Commission is adopting the rule as proposed with one exception. The Commission has permitted entities that qualify for the exception to the clearing requirement under section 2(h)(7) of the Act to report information directly to an SDR regarding how they generally expect to meet their financial obligations associated with non-cleared swaps on an annual basis in anticipation of electing the exception for one or more swaps.[17] Thus, an electing counterparty could be directly reporting the information necessary for SD and MSP compliance with proposed § 23.505(a)(3) through (5). Therefore, the Commission has modified the proposed rule to clarify that SDs and MSPs need not obtain documentation from any counterparty that claims an exception from required clearing if that counterparty is reporting directly to an SDR regarding how it generally expects to meet its financial obligations associated with its non-cleared swaps, and the SD or MSP has confirmed that the counterparty has made its annual submission.

[17] *See* End-User Exception to the Clearing Requirement for Swaps, 77 FR 42560, 42590 (July 19, 2012).

2. Reasonable Basis—§ 23.505(a)

The proposed regulation required that SDs or MSPs have a reasonable basis to believe its counterparty meets the statutory conditions required for an exception from a clearing requirement.

In response to the proposal, ISDA & SIFMA requested that the Commission clarify that the ''reasonable basis to believe'' standard in the proposed rule may be satisfied by reliance on written representations from the counterparty, absent facts that reasonably should have put the swap dealer or major swap participant on notice that its counterparty may be ineligible for the end user exception. ISDA & SIFMA argued that registrants should not have to investigate their counterparty's representations or obtain detailed representations as to the facts underlying the company's qualifications.

The Coalition for Derivatives End-Users supports the ''check-the-box'' approach in proposed § 39.6 for end users to use to qualify for the clearing exception, and is therefore concerned that the ''reasonable basis'' obligation in proposed § 23.505(a) could undermine the simplicity of the check-the-box approach. The Coalition for Derivatives End-Users argues that if SDs and MSPs must verify end user information, they may start to require unnecessary and costly documentation from end users such as legal opinions or other documents, rather than serving as passive conduits of information.

After considering these comments, the Commission has determined to adopt the rule as proposed on this issue. The Commission is of the view that, contrary to commenters' concerns, the ''reasonable basis'' standard in the proposed rule does not require independent investigation of information or documentation provided by a counterparty electing the exception from required clearing. The Commission believes that so long as an SD or MSP has obtained information, documentation, or a representation that on its face provides a reasonable basis to conclude that the counterparty qualifies for the exception under section 2(h)(7), then, in the absence of facts that reasonably should have put the SD or MSP on notice that its counterparty may be ineligible for the exception, no further investigation would be necessary. The Commission does not believe that the rule requires legal certainty on the part of SDs or MSPs.

3. Disclosure of Information by End Users

The proposed regulation required SDs and MSPs to obtain documentation that its counterparty seeking to qualify for the clearing exception generally meets its financial obligations associated with non-cleared swaps.

Better Markets argued that the proposed rule should require documentation in accordance with the Dodd-Frank Act, i.e., documentation as to how the counterparty generally meets its obligations associated with non-cleared swaps, including how it would meet any obligation to immediately fund margin upon the occurrence of a credit trigger.

ISDA & SIFMA commented that the Dodd-Frank Act merely requires a counterparty to notify the Commission as to how it generally meets its financial obligations. ISDA & SIFMA recommended that § 23.505(a)(5) be deleted or clarified such that a registrant can satisfy the requirement by obtaining a representation from its counterparty or by obtaining the documentation only with respect to swap-related obligations to the particular SD or MSP.

In the view of COPE, EEI, and CIEBA, the requirement for the SD/MSP to get information from end users is anti-competitive and inappropriate as it requires an end user to inform its SD or MSP counterparty, a potential competitor, of proprietary details about its business, including its hedging activities. Each recommended that no more than a representation from the end user should be required. COPE also objects to the rule placing the SD or MSP in the role of regulator responsible for determining if the information received is sufficient.

As explained above, the Commission is modifying the proposed rule to clarify that SDs and MSPs need not obtain documentation from any counterparty that claims an exception from required clearing if that counterparty is reporting directly to an SDR under § 39.6(b) regarding how it generally expects to meet its financial obligations associated with its non-cleared swaps, and the SD or MSP has confirmed that the counterparty has made its annual submission. Thus, any entity seeking to claim the exception from clearing may avoid revealing any information it considers sensitive to its SD or MSP counterparty by self-reporting directly to an SDR under § 39.6(b). The Commission notes that protections against release of reported proprietary information are addressed in the SDR rules finalized by the Commission.

D. Swap Confirmation—§ 23.501

Confirmation has been recognized as an important post-trade processing mechanism for reducing risk and improving operational efficiency by both market participants and their regulators. Prudent practice requires that, after coming to an agreement on the terms of a transaction, parties document the transaction in a complete and definitive written record so there is legal certainty about the terms of their agreement.

Over the past several years, OTC derivatives market participants and their regulators have paid particular attention to the timely confirmation of swaps. The Government Accountability Office (GAO) found that the rapid expansion of the trading volume of swaps, such as credit derivatives since 2002, caused stresses on the operational infrastructure of market participants. These stresses in turn caused the participants' back office systems to fail to confirm the increased volume of trades for a period of time.[18] The GAO found that the lack of automation in trade processing and the purported assignment of positions by transferring parties to third parties without notice to their counterparties were factors contributing to this backlog. If transactions, whether newly executed or recently transferred to another party, are left unconfirmed, there is no definitive written record of the contract terms. Thus, in the event of a dispute, the terms of the agreement must be reconstructed from other evidence, such as email trails or recorded trader conversations. This process is cumbersome and may not be wholly accurate. Moreover, if purported transfers of swaps, in whole or in part, are made without giving notice to the remaining parties and obtaining their consent, disputes may arise as to which parties are entitled to the benefits and subject to the burdens of the transaction.

The Commission believes the work of the OTC Derivatives Supervisors Group (ODSG) demonstrates that the industry is capable of swift movement to contemporaneous execution and confirmation. A large back-log of unexecuted confirmations in the credit default swap (CDS) market created by prolonged negotiations and inadequate confirmation procedures were the subject of the first industry commitments made by participating dealers to the ODSG.[19] In October 2005, the participating dealers committed to reduce by 30 percent the number of confirmations outstanding more than 30 days within four months. In March 2006, the dealers committed to reduce the number of outstanding confirmations by 70 percent by June 30, 2006. By September 2006, the industry had reduced the number of all outstanding CDS confirmations by 70 percent, and the number of CDS confirmations outstanding more than 30 days by 85 percent. The industry achieved these targets largely by moving 80 percent of total trade volume in CDS to confirmation on electronic platforms, eliminating backlogs in new trades.

By the end of 2011, the largest dealers were electronically confirming over 95 percent of OTC credit derivative transactions, and 90 percent were confirmed on the same day as execution (T+0). For the same period, the largest dealers were electronically confirming over 70 percent of OTC interest rate derivatives (over 90 percent of trades with each other), and over 80 percent were confirmed T+0. The rate of electronic confirmation of OTC commodity derivatives was somewhat lower—just over 50 percent, but over 90 percent for transactions between the largest dealers.[20]

The Commission further recognizes the ODSG supervisory goal for all transactions to be confirmed as soon as possible after the time of execution. Ideally, this would mean that there would be a written or electronic document executed by the parties to a swap for the purpose of evidencing all of the terms of the swap, including the terms of any termination (prior to its scheduled maturity date), assignment, novation, exchange, or similar transfer or conveyance of, or extinguishing of rights or obligations.

The Commission believes that timely and accurate confirmation of swaps is critical for all downstream operational and risk management processes, including the correct calculation of cash flows, margin requirements, and discharge of settlement obligations as well as accurate measurement of counterparty credit exposures. Timely confirmation also allows any rejections, exceptions, and/or discrepancies to be identified and resolved more quickly. To this end, in the Confirmation NPRM, the Commission proposed § 23.501, which prescribed standards for the timely and accurate confirmation of swap transactions. The Commission received approximately 27 comment letters in response to the Confirmation NPRM and considered each in formulating the final rules, as discussed below.

1. Uniform Application of Proposed Rules to All Asset Classes

In the Confirmation NPRM, the Commission solicited comments on whether certain provisions of the proposed regulations should be modified or adjusted to reflect the differences among asset classes.

In response to the request for comments, ISDA noted that the work done by the industry with the ODSG led to customization of documentation and confirmation timeframes to account for the differences between asset classes, and even between products within asset classes, but the proposed confirmation requirements do not allow for this same flexibility. However, ISDA did not suggest specific timeframes for the Commission's rules.

The FHLBs recommended that the Commission exercise caution in applying rules to all swap asset classes equally as procedures that are appropriate for interest rate swaps may be insufficient or unnecessary for other types of swaps.

The Global Foreign Exchange Division of AFME, SIFMA, and ASIFMA (GFED) commented that the Commission should take into account the high volume of transactions and wider universe of participants in the foreign exchange industry when promulgating its final rules.

The Working Group requested that the Commission revise the rules to permit current practice in the energy swap market where one party sends an acknowledgement to the other party and the acknowledgement is deemed a legally binding confirmation if the receiving party does not object within three business days. The Working Group believes this practice is efficient because (i) It eliminates the risk of open confirmations, (ii) dealers need not chase for a physically signed confirmation, and (iii) counterparties need not respond if terms are acceptable.

BG Americas & Global LNG (BGA) commented that energy commodity trading companies typically extract trading data in a batched cycle at the end of the day and generate confirmations the following day. BGA does not believe it is clear that expedited confirmation would enhance

[18] U.S. Government Accountability Office, ''Credit Derivatives: Confirmation Backlogs Increased Dealers' Operational Risks, But Were Successfully Addressed After Joint Regulatory Action,'' GAO–07–716 (2007) at pages 3–4.

[19] *See* October 4, 2005 industry commitment letter to the Federal Reserve Bank of New York, available at *http://www.newyorkfed.org/newsevents/news_archive/markets/2005/an050915.html.*

[20] *See* G15 Industry Confirmation Data dated April 4, 2012 provided by ISDA, available at *www.cftc.gov.*

transparency or reduce systemic risk and is therefore outweighed by the enormous cost for registrants that would have to add resources to perform rolling confirmations and correct errors.

As discussed further below, in section III.B.2, the Commission has made every effort to tailor the confirmation requirements by asset class based on data provided by major market participants. The Commission has achieved such tailoring by modifying the time periods for confirmation by asset class along with a generous compliance phase-in period, but has retained an otherwise uniform rule across asset classes. The Commission believes the uniform standard with appropriate differences in time periods and compliance periods will lead to efficient use of limited regulatory resources, while also reducing implementation costs for affected market participants.

2. Use of ''Enforce'' in Proposed Rules § 23.501(a)(3), § 23.502(b), § 23.502(b)(4), and § 23.503(d)

The proposed regulations require SDs and MSPs to establish, maintain, and enforce written policies and procedures to accomplish a number of requirements, including confirmation with financial entities and non-financial entities; portfolio reconciliation; valuation dispute resolution; and bilateral and multilateral compression and termination of fully offsetting swaps.

In regard to the use of ''enforce'' in these provisions, ABC & CIEBA requested that the Commission delete the term wherever it appears because SDs and MSPs are not ''registered entities'' under section 1(a)(40) of the CEA and therefore Congress did not intend for SDs and MSPs to have the self-regulatory authority to enforce compliance with their internal policies and procedures. Similarly, Freddie Mac commented that the requirement in the proposed rules that SDs enforce policies designed to ensure confirmation with non-SD, non-MSP counterparties within the short deadlines mandated by the proposed rules could result in SDs exerting undue pressure on such counterparties to quickly assent to the terms of a trade as framed by the SD in the form of a condition to execution of a swap, with the risk that the swap could become void or otherwise fail.

The Commission is sensitive to these concerns, and has accordingly modified the proposed rules by replacing each instance of the term ''enforce'' with the term ''follow.'' The Commission observes that the intent of the term ''enforce'' in the proposed rules was to require SDs and MSPs to in fact follow the policies and procedures established to meet the requirements of the proposed rules, rather than to require an SD or MSP to enforce its internal policies and procedures against third parties.

3. Definition of ''Acknowledgement''—§ 23.500(a)

The proposed regulations defined ''acknowledgement'' to mean ''a written or electronic record of all of the terms of a swap signed and sent by one counterparty to the other.''

Commenting on this definition, GFED requested that the Commission clarify whether an ''acknowledgement'' is the same as a ''trade affirmation'' in the FX market, which is matching of economic fields only, and MFA recommended that the Commission revise the definition to provide that an acknowledgement need only specify the primary economic terms of a swap (rather than all terms).

Despite these comments, the Commission is adopting the definition of acknowledgement as proposed. The intent of the definition was to make clear that an SD or MSP must provide its non-SD, non-MSP counterparties with a complete record of all terms of an executed swap transaction. The Commission believes that to achieve the timely confirmation goals of § 23.501, mistaken, misunderstood, or disputed terms must be identified quickly. To do so, a counterparty needs to see documentation reflecting all of the terms of the swap transaction as the SD or MSP understands them. The Commission therefore does not agree with commenters that an acknowledgement need contain only the primary economic terms of a swap transaction. In reaching this conclusion, the Commission recognizes that requiring delivery of an acknowledgement containing all terms may require the parties to agree to more terms at execution than are agreed under some current market practices, but, given the critical role confirmation plays in all downstream operational and risk management processes, the Commission believes that any additional pre-execution burden imposed is justified.

4. Definition of ''Confirmation''—§ 23.500(c)

The proposed regulations defined ''swap confirmation'' to mean ''the consummation (electronically or otherwise) of legally binding documentation (electronic or otherwise) that memorializes the agreement of the parties to all the terms of the swap. A confirmation must be in writing (whether electronic or otherwise) and must legally supersede any previous agreement (electronically or otherwise).''

Reacting to this definition, ABC & CIEBA explained that where a lead fiduciary for a pension fund negotiates ISDA documentation on a relationship basis, there sometimes will be a provision that the master agreement's terms legally supersede the confirmation's terms unless the fiduciary entering the plan into the swap represents that inconsistent terms in the confirmation are more beneficial to the plan. ABC & CIEBA therefore requested that the Commission clarify that the phrase ''legally supersede any previous agreement'' is only intended to apply to prior agreements outside the scope of the package of documentation that makes up the master agreement between the parties (i.e., master agreements, credit support agreements, all confirmations, etc.).

Similarly, the Asset Management Group of SIFMA (AMG) explained that in current practice, some clients to asset managers require that terms in the confirmation of a swap cannot supersede conflicting terms in a client's master agreement. AMG therefore also recommended that the Commission clarify the proposed rule to provide that a confirmation will not legally supersede the contractual arrangements agreed on by the parties.

On a different tack, GFED requested clarification as to whether ''confirmation'' means only actual legal confirmation execution or whether it may also include matching services that do not provide a legally binding confirmation of all terms, but merely affirmation of trade economics, and ISDA requested clarification that confirmation may be accomplished by use of matching services under which some buy-side firms ''affirm'' trades.

Jason Copping offered an alternative definition of ''confirmation'' under which a swap is confirmed when all parties accept the terms and no change to the terms would be legally binding until all parties agree to such changes.

In response to these comments, the Commission reiterates that the intent of the proposed rule was to require the terms of a confirmation to include all of the binding terms of the swap. This definition is the same definition adopted by the Commission in the Swap Data Recordkeeping and Reporting rules in part 45 of the Commission's regulations.[21] In addition, under the Swap Data Recordkeeping and Reporting rules, all terms agreed in a

[21] *See* 17 CFR 45.1.

confirmation must be reported to an SDR.[22] Therefore, in addition to the need for all terms to be confirmed for purposes of downstream operational processing and risk management, the Commission has a strong interest in consistent rules for the swap market. For these reasons, the Commission is adopting the definition of confirmation as proposed.

With respect to the comments of ABC & CIEBA and AMG, the Commission understands the practice explained by these commenters to mean that some confirmations of swaps incorporate by reference certain terms that are delineated in master agreements and that the parties have agreed that such terms trump any inconsistent terms that may appear in a confirmation. The Commission clarifies that the rules adopted herein do not prohibit the practice of incorporation by reference. Therefore, if counterparties want to include certain standard provisions in their master agreements that will control each swap transaction executed, this approach would be acceptable so long as they ensure that their books and records and the confirmation data reported to an SDR reflects the actual terms of each swap transaction. Given the Commission's interest in ensuring the integrity of data reported to an SDR, contradictory or conflicting swap transaction terms in an SD's or MSP's books and records or in data reported to an SDR when reconciled with an SD's or MSP's books and records could indicate non-compliance with the both the confirmation rule adopted herein and the swap data reporting rules under part 45 of the Commission's regulations.

Moreover, the Commission clarifies that any specific agreed-upon collateral requirements in a confirmation, which may go beyond what exists in the collateral support arrangements under the swap trading relationship documentation, would be required to be confirmed according to the timeframes discussed below.

5. Definition of Financial Entity–§ 23.500(e)

The Commission proposed to define ''financial entity'' to have the same meaning as given to the term in section 2(h)(7)(C) of the Act, excepting SDs and MSPs. Subsequent to the proposal, the Commission proposed a number of rules that contained slightly differing definitions of the term.[23] The Commission has therefore determined to revise the definition of ''financial entity'' for purposes of the rules adopted herein to be consistent with its other rules applicable to SDs and MSPs. Thus, ''financial entity'' has been defined in the rule adopted in this release to mean ''a counterparty that is not a swap dealer or a major swap participant and that is one of the following. (1) A commodity pool as defined in section 1a(5) of the Act, (2) A private fund as defined in section 202(a) of the Investment Advisers Act of 1940, (3) An employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income and Security Act of 1974, (4) A person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature as defined in section 4(k) of the Bank Holding Company Act of 1956, and (5) a security-based swap dealer or a major security-based swap participant.''

6. Electronic Execution and Processing—§ 23.501(a)(1) & (2); Definition of ''Processed Electronically''—§ 23.500(j)

The proposed regulations prescribed trade acknowledgement delivery and confirmation deadlines for swap transactions that are executed and processed electronically, and different deadlines for swaps that are not executed electronically but are processed electronically. The proposed regulations provided that ''processed electronically'' means ''to be entered into a swap dealer or major swap participant's computerized processing systems to facilitate clearance and settlement.'' In addition, the Commission requested comment on whether the term ''processed electronically'' required more clarification, and, if so, what definition would be effective and flexible enough to accommodate future market innovation.

In response to the proposal, ABC & CIEBA urged the Commission to ensure that the proposed confirmation rule does not indirectly impose on benefit plans processes that will require third-party service providers or new technology by expressly stating that a party to an uncleared swap that is not an SD or MSP has the right to determine whether the confirmation will occur electronically or manually. AMG also recommended that a party to an uncleared swap that is not an SD or MSP should have the right to determine whether the confirmation will occur electronically or manually.

The Working Group and MFA warned that the Commission should not mandate confirmation through an electronic matching platform because electronic matching is unlikely to be able to capture all terms of customized transactions. Chatham Financial Corp. (Chatham) also argued that the Commission should not mandate confirmation through an electronic matching platform, because such a mandate could preclude end-users from entering into swaps not yet available on matching platforms and could increase costs for end-users that do not engage in the volume of swaps necessary to justify the additional costs of connecting to electronic matching platforms.

ISDA commented that electronic execution and processing standards should be phased and aspirational because development by the industry will be required to meet the timelines of the proposed rules. ISDA also argued that the proposed life cycle confirmation requirement will undermine the move to electronic execution and processing, because not all life cycle events are currently supported by electronic platforms across asset classes.

MarkitSERV supports the Commission's goal of having as many transactions as possible be executed on electronic platforms, and recommended that the Commission require all swap transaction information to be communicated electronically if a registrant has the ability to do so, and encourage (but not require in all cases) the use of electronic matching and confirmation platforms.

Many commenters raised questions regarding what would constitute electronic processing. MFA requested that the Commission clarify if ''processed electronically'' only refers to swaps confirmed through electronic confirmation or matching services, or whether ''processed electronically'' could refer to a registrant entering trade information into its trade capture system, the generation of an acknowledgement from such system and the forwarding of such acknowledgement to a counterparty by facsimile, email, or other electronic method, while GFED requested that the Commission clarify whether a SWIFT confirmation would meet the definition of ''processed electronically'' under the proposed rules. The Working Group also questioned whether confirming a swap via email would constitute electronic processing. The FHLBs requested that the Commission clarify if ''processed electronically'' only refers to swaps confirmed through electronic confirmation or matching services, while ISDA recommended that the Commission not define ''processed electronically'' to include all

[22] *See* 17 CFR 45.3.

[23] *See e.g.,* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 FR 23732, 23744 (Apr. 28, 2011).

transactions for which some element of the transaction is captured or processed through electronic means, but define it with reference to a firm or platform's ''middleware,'' which will actually drive the process. Finally, MetLife recommended that the Commission more clearly define the terms ''processed electronically'' and ''executed electronically'' because MetLife needs more information to determine whether the proposed time frames for confirmation are realistic within current market capabilities.

Having considered these comments, the Commission acknowledges the concerns expressed by market participants regarding the coerced use of matching platforms and is accordingly modifying the proposed rule to delete the definition of ''processed electronically'' and delete the provisions of the rule mandating acknowledgement and confirmation deadlines for swaps that are executed or processed electronically. In place of these provisions, the rule has been modified to provide that swap transactions among SDs and MSPs or between such registrants and financial entities should be confirmed as soon as technologically practicable, but in any event by the end of the first business day following the day of execution (as modified for time zone and business day differences, discussed in detail below). The Commission believes this change will eliminate any confusion as to whether a method of swap execution and confirmation qualifies as ''electronic.'' As explained further below, the modified rule would provide a single deadline for confirmation of swap transactions among registrants, a single deadline for confirmation of swap transactions between registrants and financial entities, and a single deadline for confirmation of swap transactions between registrants and all other entities, with appropriate adjustments of the compliance deadlines by swap asset class for implementation of the rule.

7. Delivery of Draft Acknowledgement to Non-SD, Non-MSP Counterparties § 23.501(a)(3)

Proposed § 23.501(a)(3) required SDs and MSPs to establish a procedure such that, prior to execution of any swap with a non-SD or non-MSP, the registrant furnish to a prospective counterparty a draft acknowledgment specifying all terms of the swap transaction other than the applicable pricing and other relevant terms that are to be expressly agreed at execution.

Commenting on the proposal, ISDA argued that the requirement to provide a draft acknowledgement prior to execution may cause loss of timely execution opportunities, and may require end-users to engage significant legal resources for review of all proposed transactions, rather than just executed transactions. ISDA recommended that non-dealer counterparties be permitted to waive the delivery of draft acknowledgements. MFA similarly argued that the proposed rule will (i) Prevent end users from executing promptly when the market is favorable; (ii) cause end users to concede on terms in order to get timely execution; (iii) cause a decrease in the number of transactions, which will decrease liquidity and increase volatility; and (iv) cause wider bid/ask spreads or less market-making because of an increase in risk between pricing and execution. Freddie Mac also believes that the proposed rule would delay prompt execution of hedging transactions because end users will be required to review draft acknowledgements.

MarkitSERV argued that requiring a draft acknowledgement is unnecessarily burdensome because (i) multiple SDs competing for a trade would all be required to furnish a draft acknowledgement, and (ii) many transactions executed through automated electronic systems can complete a confirmation promptly after execution. MarkitSERV recommended that the Commission require draft acknowledgements to contain only terms necessary to determine price (rather than all terms) and only require delivery of draft acknowledgements for swaps that cannot be processed electronically and where confirmation is not reasonably expected to be completed within 24 hours.

On the other hand, ABC & CIEBA agreed with the Commission's proposal to require all terms, except terms related to price, be disclosed in writing prior to the time of execution. AMG also supported the proposed rule, but recommended that the Commission revise the rule to provide an exception for swaps where the parties have previously agreed to non-pricing-related terms.

Finally, MetLife recommended that the Commission revise the proposed rule to specifically indicate which party is responsible for delivery of an acknowledgement and which party is responsible for the return confirmation.

Having considered the commenters' concerns, but cognizant of the support for the proposed rule by some commenters, the Commission is modifying the proposed rule to require delivery of a draft acknowledgement, but only upon request of an SD's or MSPs' non-SD, non-MSP counterparty prior to execution.

With respect to MetLife's comment, the Commission believes the rule as proposed clearly states that it is the SD's or MSP's responsibility to deliver an acknowledgement when trading with a counterparty that is not an SD or MSP. The SD or MSP is required to have policies and procedures reasonably designed to ensure that its counterparty returns a confirmation or otherwise completes the confirmation process. With respect to trades solely among SDs and MSPs, the Commission does not believe it is necessary to prescribe responsibility for delivery of an acknowledgement because both parties would be required to comply with the confirmation deadline set forth in the rule as adopted herein.

8. Time Period for Confirmation—§ 23.501(a)(1) & (3)

Proposed § 23.501 provided time periods for confirmation as set forth at 75 FR 81519, 81531 (Dec. 28, 2010).

The Commission received 27 comments with respect to the proposed rule's time periods for confirmation. Below, the comments are described according to the following categories:

(A) General comments on the proposed time periods;

(B) Comments on proposed time periods for confirmation with non-SDs and non-MSPs;

(C) Comments on time periods for confirmation with financial entities;

(D) Comments on confirmation of swaps between parties in different time zones; and

(E) Comments on confirmation of swaps executed near end of trading day.

(A) Comments on Time Periods Generally

ISDA stated that the proposed rules place an unnecessary burden upon the inception of transactions, may increase risk by leading to needless disputes and operational lapses, and require substantially more than is necessary to create an initial record of a legally binding agreement. ISDA also argued that: (i) The time periods proposed are impractical as certain terms required to be included in a confirmation may not be known on the same calendar day as execution (e.g., initial rates may follow trade commitment by days); and (ii) valuation methodologies required to be agreed prior to execution pursuant to proposed § 23.504(b)(4), may also slow down the confirmation process to the extent such methodologies are required to be reflected in the confirmation. ISDA recommended an alternative framework:

• Execution of a swap on a SEF or DCM or clearing a swap should be deemed to satisfy any confirmation requirements.

• Electronic execution and processing standards should be phased and aspirational as development by the industry will be required.

• The Commission should conduct a study in order to better understand the potential barriers to complying with the proposed timelines for confirmation in each asset class.

• The Commission should institute an approach similar to that utilized by the ODSG; an ongoing dialogue between the Commission and leaders in the industry to obtain a commitment from the industry to tighten confirmation timeframes over an extended period, with existing risk mitigants to address Commission concerns in the interim.

The Working Group also objected to the time periods between execution and confirmation in the proposed rules because: (i) The time periods effectively will require all terms of a swap to be negotiated prior to execution, and that such requirement will disadvantage the party that is most sensitive to timing of market conditions and may force that party to accept less optimal economic terms or reduced negotiating leverage in order to meet the confirmation deadline; and (ii) the Commission has not articulated any benefit from the requirement that non-registrants confirm a swap no later than the day after execution that would outweigh the cost for most non-registrants to comply with the rule.

MarkitSERV commented that the time periods specified in the proposed rules for confirmation are not feasible in many cases and recommended the following alternative:

• The time period within which confirmation is required to be completed should not begin with execution, but only from the point when all relevant data and information to define the swap has been obtained (e.g., allocations).

• Acknowledgements should be sent within a time period after all information has been obtained and confirmation should be completed within a time period after an acknowledgement has been received.

• Non-electronically executed and non-electronically processed transactions should be confirmed within 24 hours of execution, rather than within the same calendar day.

• The confirmation requirement should consist of ''economic tie-out'' of key economic terms rather than confirmation of all terms.

• Electronic processing should be defined to include the capability for electronic communication.

AMG argued that same calendar day or next business day confirmation may not be appropriate for complex or customized uncleared swaps, including swaps entered by asset managers that must allocate block trades among their clients. AMG also recommended that the Commission revise the proposed rules to provide for a delay in confirmation for legitimate disputes between the parties if the parties are seeking to resolve the dispute in a timely fashion.

BGA commented that the 15 minute and 30 minute deadlines for confirmation or acknowledgement in the proposed rules are unworkable and inconsistent with current practice. BGA stated that energy commodity trading companies typically extract trading data in a batched cycle at the end of the day and generate confirmations the following day. BGA does not believe it is clear that expedited confirmation would enhance transparency or reduce systemic risk and is therefore outweighed by the enormous cost for registrants that would have to add resources to perform rolling confirmations and correct errors. BGA also argued that swaps executed on electronic platforms and through broker/dealers as clearing agents should not require a confirmation.

Chatham argued that the proposed timeframes for confirmation could result in decreased accuracy as parties will rush to complete transaction documentation without thorough review.

The FHLBs stated that currently available electronic swap processing systems do not support customized terms in swaps used by the FHLBs and therefore the same business day deadline is not sufficient for swaps that require manual processing. The FHLBs also stated that for some swaps (e.g., forward settling interest rate swaps), all terms may not be known when the swap is executed.

MetLife requested that the Commission extend the timeframe for delivery and return of confirmations for transactions not executed on a SEF or DCM as such are often highly structured and customized and it is unreasonable to expect parties to generate a confirmation within the timeframe set forth in the proposed rules. MetLife recommended that the Commission revise the proposed rules to provide three business days following execution for delivery of an acknowledgement for such transactions and at least two business days following receipt of an acknowledgement to review and return a confirmation.

GFED stated that the various deadlines are significantly too short for many FX swap trades and inappropriately rely on both parties complying with the proposed rules. GFED recommends that the Commission revise the proposed rules, as such are applied to FX swap trades, taking into account: (i) The method of confirmation (electronic/paper); (ii) the complexity of the underlying transaction (e.g., vanilla options vs. basket options); and (iii) the counterparty type.

MFA recommended that the Commission specify no timeframe for confirmation, allowing parties to execute whenever market conditions are favorable with the expectation that they may negotiate non-economic terms later.

(B) Comments on Time Periods for Confirmation With Non-SDs and Non-MSPs

With respect to the proposed confirmation time periods for swaps between an SD or MSP and a non-SD or non-MSP specifically, ISDA commented that the rule lacks clarity on how non-registrant counterparties can be required to comply with the confirmation requirements. The FHLBs echoed ISDA's comment, arguing that the proposed timeframe may lead SDs and MSPs to put undue pressure on end users to execute confirmations before such parties have had an opportunity to fully review such confirmations. To alleviate this concern, the FHLBs argued that the proposed rules should allow SDs and MSPs at least 48 hours to provide end users with an acknowledgement, at least two business days for end users to review acknowledgements and execute confirmations, and provide for an exception from the confirmation deadlines for complex or unique swap transactions (as determined by the parties) upon notice to the Commission detailing the unique or complex aspects of the swap and the date by which a confirmation will be executed.

Chatham recommended an alternative confirmation requirement for swaps with non-SDs and non-MSPs:

• For electronically confirmed swaps, an acknowledgement would be required to be submitted electronically on the same or next business day after execution, and swap terms would be required to be affirmed, matched or otherwise confirmed or a notice of discrepancy provided within three business days; any discrepancy would be required to be resolved and the swap confirmed within five business days after the discrepancy was communicated.

- For non-electronically confirmed swaps, an acknowledgement would be required to be issued within one business day of execution; a notice of discrepancy provided within five business days; and confirmation required within 30 days.

Dominion commented that the energy industry standard is to achieve confirmation of uncleared swaps not executed on an electronic platform within three business days, and that such standard is often documented in participants' existing master agreements. Dominion thus argued that the proposed next business day confirmation requirement may conflict with end user contractual rights and obligations, and may cause end users to incur costs even though the Commission has not articulated a justifiable benefit to end users or the market.

(C) Comments on Time Periods for Confirmation With Financial Entities

Specifically with respect to confirmation of swap transactions between an SD or MSP and a financial entity, ABC & CIEBA stated that the ''same business day'' confirmation requirement would impose costly increases in operational capacity for pension funds, which may discourage use of swaps or limit trading to earlier parts of the trading day. ABC & CIEBA recommended that the Commission provide for a ''close of next business day'' time limit for benefit plans and other non-SD, non-MSP counterparties. AMG also argued that financial entities should not be subject to shorter time periods for confirmation than non-financial end-users because many may not have the operational resources to meet the demands of the proposed rules. Similarly, Freddie Mac argued that it often takes several business days to correct and execute confirmations, and the proposed rules would not permit sufficient time for correction of draft confirmations or resolution of disputes over trade terms.

While MFA agreed with the proposed longer time period for confirmation for swap transactions between an SD or MSP and counterparties that are not SDs or MSPs, but objected to a shorter time period for financial entity end users as compared to other end users. MFA argued that designation as a financial entity does not necessarily correlate with a large swap portfolio or being highly sophisticated with respect to swaps, and the short time period for confirmation applicable to financial entities under the proposed rules may cause unwarranted disadvantages in negotiation of swap terms with SDs and MSPs.

Finally, the OCC believes that the same calendar day trade confirmation requirement for financial entities would eliminate or significantly reduce customized transactions between registrants and such entities, leading to less effective risk management. The OCC argued that the short confirmation deadline will require the parties to negotiate all terms prior to execution, leading to the unnecessary expenditure of resources for transactions that are never executed. The OCC further argued that negotiation prior to execution will delay execution, which itself can create risks in fast moving markets.

(D) Comments on Confirmation of Swaps Between Parties in Different Time Zones

The Commission received several comments concerned with the proposed time periods for confirmation as applied to swap transactions between parties in different time zones.

Commenting on this aspect of the proposed rule, ISDA stated that cross-border transactions frequently require more than one day to confirm due to business day and time zone differences; Chatham and GFED also commented that the proposed timeframes fail to account for coordination across time zones.

(E) Comments on Confirmation of Swaps Executed at End of Day

The Commission also received several comments concerned with the proposed same day confirmation requirement for swap transactions among SDs and MSPs and between an SD or MSP and a financial entity as applied to swap transactions executed near the end of the trading day.

In this regard, ISDA, Chatham, the FHLBs, AMG, and GFED each commented that the rules should account for transactions executed toward the end of the business day that leave little or no time for same-day confirmation. To account for this issue, AMG recommended that parties should be given no less than 24 hours to confirm trades, while the FHLBs recommended that swap transactions executed after 3:00 p.m. EST should be considered executed on the immediately following business day.

Commission Response

The Commission has considered the many comments with respect to the proposed time periods for confirmation and has decided to revise the proposed rule in a number of ways to better attune the rule to the intention of the Commission's proposal, the concerns raised by commenters, and the needs of the market. The Commission has revised the proposed rule as discussed below.

The proposed time periods for swaps executed or processed electronically have been replaced in their entirety by a requirement that, subject to a compliance phase-in schedule, all swaps among SDs and MSPs or between SDs, MSPs, and financial entities be confirmed ''as soon as technologically practicable,'' but no later than the end of the first business day following the day of execution.[24] The Commission believes this change still requires electronically executed or processed trades to be confirmed quickly, but is responsive to commenters that have provided examples of processing operations that contain some electronic elements but are not ''straight-through'' in the sense intended by the proposed rules and therefore are incapable of meeting the proposed 15 or 30 minute deadlines.

In revising the rule, the Commission also was persuaded by the comments of market participants that are concerned with the possibility of pressure by their dealer counterparties to make costly changes to their operating systems in order to meet the required confirmation deadlines. The Commission notes that these changes also make the confirmation rule consistent with the real-time public reporting rules and the rules mandating deadlines for the reporting of swap data to SDRs, both of which use ''as soon as technologically practicable'' as the applicable standard.[25]

With respect to the proposed time periods for swaps executed between SDs and MSPs and counterparties that are not SDs, MSPs, or financial entities, the Commission has modified the rule to require, subject to a compliance phase-in schedule, policies and procedures reasonably designed to ensure that a confirmation is executed no later than the end of second business day after execution.[26] The Commission believes this change will afford SDs and MSPs an

[24] Compare with ESMA Draft Technical Standards, Article 1 RM, subsection 2, (stating that uncleared OTC derivatives ''shall be confirmed, where available via electronic means, as soon as possible and at the latest by the end of the same business day.'').

[25] *See* 17 CFR 43.2, Real-Time Public Reporting of Swap Transaction Data, 77 FR 1182, 1243–44 (Jan. 9, 2012); 17 CFR 45.3, Swap Data Recordkeeping and Reporting Requirements, 77 FR 2136, 2199–2200 (Jan. 13, 2012).

[26] Compare with ESMA Draft Technical Standards, Article 1 RM, subsection 3, (stating that uncleared OTC derivatives ''shall be confirmed as soon as possible and at the latest by the end of the second business day following the date of execution.'').

extra business day to confirm their swap transactions with non-financial entities and is more consistent with the time periods suggested by commenters.

In response to commenters, as discussed above, the Commission is revising the proposed rule to state explicitly that swaps executed on a SEF or DCM, and swaps cleared by a DCO, will be deemed to have met the confirmation requirements so long as: (i) confirmation of all terms of the transaction takes place at the same time as execution on a SEF or DCM; or (ii) the parties submit the swap for clearing no later than the time that confirmation would otherwise be required and the DCO confirms the terms of the swap upon acceptance for clearing. To ensure that no swap transaction goes unconfirmed, the modified rule also contains a backstop requirement for SDs and MSPs to confirm a swap for which the registrant receives notice that a SEF, DCM, or DCO has failed to provide a confirmation on the same day as it receives such notice.

Based on the comments received, the Commission is also modifying the proposed rule to adjust the confirmation deadline for swaps among SDs and MSPs and between SDs, MSPs, and financial entities whenever the parties (i) execute a swap near the end of the trading day (i.e., after 4 p.m.), or (ii) execute a swap with a counterparty located in a different time zone. The Commission has been persuaded by commenters that registrants should not be required to maintain back-office operations 24 hours a day or 7 days a week in order to meet the proposed confirmation deadlines. The Commission has been particularly sensitive to comments stating that the proposed confirmation deadlines may discourage trade execution late in the day. Specifically, the Commission has made the following changes to the proposed rule:

• To account for time-zone issues, the ''day of execution'' has been defined to be the calendar day of the party to the swap that ends latest, giving the parties the maximum amount of time to confirm the transaction within the deadlines required by the rule.

• To account for end-of-day trading issues, the definition of ''day of execution'' deems such day to be the next succeeding business day if execution occurs after 4:00 p.m. in the place of either counterparty.

• To account for non-business day trading, the ''day of execution'' is also deemed to be the next succeeding business day if execution occurs on a day that is not a business day.[27]

The Commission notes that this approach is consistent with the business day definition in the Swap Data Recordkeeping and Reporting Rules finalized by the Commission in December 2011.[28]

Despite several commenters' concerns, however, the Commission has declined to modify the proposed requirement that SDs and MSPs establish policies and procedures reasonably designed to ensure that swaps with financial entities meet the same confirmation deadlines as swaps among SDs and MSPs. While the Commission recognizes that an SD or MSP may not be able to ensure that a non-registrant financial entity abides by the confirmation deadline in each and every instance, it believes that ''policies and procedures reasonably designed to ensure'' is not the same as requiring a guarantee of compliance. Therefore, the Commission believes that the rule contains sufficient flexibility because it only requires that the SDs and MSPs make reasonable efforts to confirm swaps with financial entities by the stated deadline.

As discussed below in section III.B.2, the Commission is phasing in compliance with each of the time periods required under § 23.501. This compliance schedule is set forth in the rule text and seeks to further address concerns from market participants regarding the timing of compliance.

9. Allocation of Block Trades

The proposed regulations did not address confirmation in the context of block trades that must be allocated prior to confirmation.

With respect to the allocation of block trades, ISDA argued that the proposed confirmation rule will be difficult for asset managers to implement because asset managers often execute block trades and then allocate the block to two or more clients, a process than can take significantly longer than the confirmation time periods because the allocation process hinges on compliance processes or receipt by investment managers of instructions from their clients. In ISDA's view, if finalized as proposed, the rule could force investment managers to execute individual trades for their clients, increasing pricing and operational costs. AMG echoed this point.

Intercontinental Exchange, Inc. (ICE) also pointed out that the confirmation deadlines in the proposed rules may make it impossible for asset managers to make post-execution allocation of trades. ICE stated that its own trade processing service for CDS requires that trades be allocated within two hours of execution and recommended that the Commission adopt a similar standard.

While the Commission acknowledges that allocation of block trades is required to achieve confirmation, it notes that the modifications to the rule outlined above replaces the 15 and 30 minute confirmation deadlines with a requirement that swaps be confirmed ''as soon as technologically practicable, or in any event by the end of the first business day following the day of execution.'' The Commission thus believes that the rule as modified allows registrants and the asset managers for their counterparties the flexibility to work out an efficient and timely allocation process within the deadlines for confirmation as adopted in this release. The Commission also notes that recent amendments to Commission regulation § 1.35 address the allocation issue by requiring that account managers must provide allocation information to the counterparty no later than the end of the calendar day that the swap was executed.[29]

10. Time Period for Delivery of Acknowledgement—§ 23.501(a)(2)

Proposed § 23.501(a)(2) set forth at 75 FR 81519, 81531 (Dec. 28, 2010) required SDs and MSPs to send an acknowledgement containing all of the terms of a swap transaction to each counterparty that is not an SD or MSP.

In response to the proposal, ISDA asserted that the time periods proposed are impractical because: (i) Certain terms required to be included in an acknowledgement may not be known on

[27] Compare with ESMA Draft Technical Standards, Article 1 RM, subsection 3, (stating that where an uncleared OTC derivative transaction ''is concluded after 16.00 local time, or when the transaction is concluded with a counterparty that is located in a different time zone that does not allow for same day confirmation, the confirmation shall take place as soon as possible and at the latest by the end of the next business day.'')

[28] *See* 71 CFR 45.1, Swap Data Recordkeeping and Reporting, 77 FR 2136, 2197 (Jan. 13, 2012).

[29] *See* Customer Clearing Documentation, Timing of Acceptance for Clearing, and Clearing Member Risk Management, 77 FR 21278, 21306 (Apr. 9, 2012) (providing that ''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.'').

the same calendar day as execution (e.g., initial rates may follow trade commitment by days); and (ii) valuation methodologies required to be agreed prior to execution pursuant to proposed § 23.504(b)(4) may also slow down the acknowledgement process to the extent such methodologies are required to be reflected in the acknowledgement. Similarly, MarkitSERV recommended that acknowledgements be sent within a time period after all information has been obtained (rather than after execution), while AMG argued that the time periods are unnecessarily short and do not bear a reasonable relationship to the systemic risk goals of the Dodd-Frank Act, would be burdensome for uncleared swaps which merit more individualized treatment, and could impose excessive costs on swap market participants.

Based on these comments and other considerations discussed above, the Commission has revised the proposed rule to delete the 15 and 30 minute acknowledgement delivery deadlines and replace them with a requirement, subject to a compliance phase-in schedule, that an acknowledgement be provided ''as soon as technologically practicable, but in any event by the end of the day of execution;'' to state explicitly that the acknowledgement requirement will be deemed satisfied by executing a swap on a DCM or SEF, or clearing the swap through a DCO; and to provide for an adjustment to the ''day of execution'' to account for time-zone differences and end-of-day trading issues. The Commission believes these changes are responsive to the foregoing comments. However, in response to the comments of ISDA and MarkitSERV regarding terms that may not be known until after the acknowledgement delivery deadline has passed, the Commission believes that an acknowledgement could meet the requirement that all terms be included by describing where and when the ''to be determined'' terms will be obtained and provide for incorporation by reference once the terms are known.

As discussed below in section III.B.2, the Commission is phasing in compliance with each of the time periods required under § 23.501, including the acknowledgement requirement.

11. Confirmation Through Execution on a SEF or DCM and/or Clearing on a DCO

The proposed regulations did not contain specific provisions regarding confirmation through execution on a SEF or DCM, or clearing on a DCO. However, in the Confirmation NPRM, the Commission stated: ''It is important to note at the outset, that the Commission expects that swap dealers and major swap participants would be able to comply with each of the proposed rules by executing a swap on a swap execution facility (SEF) or on a designated contract market (DCM), or by clearing the swap through a derivatives clearing organization (DCO). For swaps executed on a SEF or a DCM, the SEF or DCM will provide the counterparties with a definitive written record of the terms of their agreement, which will serve as a confirmation of the swap. Similarly, if a swap is executed bilaterally, but subsequently submitted to a DCO for clearing, the DCO will require a definitive written record of all terms to the counterparties' agreement prior to novation by the DCO; this too would serve as a confirmation of the swap.'' [30]

Commenting on this aspect of the proposal, Chris Barnard supported the idea that SDs and MSPs will be able to comply with the proposed rule by executing a swap on a SEF, a DCM, or by clearing the swap through a DCO, and supported the greater use of these facilities. Each of ISDA, CME, ICE, The Working Group, the FHLBs, MetLife, MFA, and Chatham recommended that the Commission explicitly clarify in the final rules that the confirmation processes of SEFs, DCMs, and DCOs satisfy the requirements of the confirmation rules.

MarkitSERV however asserted that the Commission should not presume that execution on a SEF will automatically result in confirmation of a swap because the execution and confirmation of a swap are separate and distinct activities, and it is possible that SEFs and DCMs may offer execution services without necessarily providing confirmation services. MarkitSERV recommended that the Commission prescribe standards for any confirmation service that may be offered to ensure that SEFs and DCMs produce a complete, legally binding record of each swap based on a recognized legal framework. MarkitSERV also recommended that SEFs and DCMs be permitted to allow qualified third parties to perform the confirmation function after swap execution.

Based on these comments and other considerations discussed above, the Commission has revised the proposed rules to state explicitly that swaps executed on a SEF or DCM, and swaps cleared by a DCO, will be deemed to have met the confirmation requirements so long as: (i) confirmation of all terms of the transaction takes place at the same time as execution on a SEF or DCM; or (ii) the parties submit the swap for clearing no later than the time that confirmation would otherwise be required and the DCO confirms the terms of the swap upon acceptance for clearing. Under § 39.12(b)(8), DCOs are required to provide a confirmation of all the terms of each cleared swap, and this confirmation is required to take place at the same time the swap is accepted for clearing.[31] Under Core Principle 11 for DCMs and § 38.601, DCMs must clear all transactions executed on or through the DCM through a Commission-registered DCO.[32] In essence, confirmation for DCM-executed swaps will occur either at the same time as execution or upon submission to a DCO. The Commission's rules for SEFs, including the proposed confirmation rule, § 37.6(b), have yet to be finalized.[33] However, to the extent that a SEF offers confirmation services upon execution or provides for the timely submission of a swap for clearing, SDs and MSPs would be able to take advantage of the provisions of § 23.501(a)(4).

With respect to MarkitSERV's comments, the Commission notes that if a SEF or DCM does not provide confirmation services, the confirmation deadlines of the rule will control. The standards for confirmation by SEFs and the ability of a SEF to allow a third party to provide the confirmation service are outside the scope of this adopting release.

12. Confirmation of Swap Transaction and Ownership Modifications—§ 23.500(m)

The proposed regulations required SDs and MSPs to comply with the confirmation requirements for all ''swap transactions.'' The proposed regulations defined ''swap transaction'' as any event that results in a new swap or in a change to the terms of a swap, including execution, termination, assignment, novation, exchange, transfer, amendment, conveyance, or

[30] *See* Confirmation NPRM at 81520.

[31] *See* Derivatives Clearing Organization General Provisions and Core Principles, 76 FR 69334, 69438 (Nov. 8, 2011). Under § 39.12(b)(7), DCOs are required to 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 on or subject to the rules of a DCM or a SEF. *See* Customer Clearing Documentation, Timing of Acceptance for Clearing, and Clearing Member Risk Management, 77 FR 21278, 21309 (April 9, 2012).

[32] *See* Core Principles and Other Requirements for Designated Contract Markets, 77 FR 36612, 36705 (June 19, 2012).

[33] *See* Core Principles and Other Requirements for Swap Execution Facilities, 76 FR 1214, 1240 (Jan. 7, 2011).

extinguishing of rights or obligations of a swap.

In response to this requirement, ISDA stated that some ''market'' life cycle events (e.g., option exercise notices, various notices sent by calculation agent, etc.) captured by the definition of ''swap transaction'' are already described in the original confirmation and sees no benefit to confirming those events. ISDA distinguished ''market'' from ''legal'' life cycle events (e.g., novations and terminations), which currently are confirmed. ISDA stated that industry methodologies have been developed around the confirmation of legal life cycle events at great time and expense and recommends that the Commission defer to industry standards and to allow market participants to bilaterally agree that certain life cycle events do not require subsequent confirmation. ISDA believes that the proposed life cycle confirmation requirement will undermine the move to electronic execution and processing, because not all life cycle events are currently supported by electronic platforms across asset classes.

BGA recommended that the Commission revise the proposed definition of ''swap transaction'' to include only those life-cycle events that impact the economics or settlement of the trade, as current practice of energy commodity trading companies is not to send new confirmations for events like novations.

GFED believes that the Commission should exclude FX swaps from any life-cycle event confirmation requirement. GFED states that efficient processes around trade events already exist (e.g., option exercises confirmed as new trades), and that ISDA has developed a novation protocol in wide use that is moving the industry toward novation without confirmation.

While MFA supports confirmation of life-cycle events, it recommended that the Commission not mandate specific timing requirements for the confirmation of life-cycle events. MFA states that once a life-cycle event occurs, parties to a swap may need to renegotiate certain trade terms and a timing requirement is likely to disadvantage end users in such negotiation with SDs.

The Working Group recommended that confirmation of changes to material economic or legal terms of a swap should be confirmed, but the confirmation should only be required within a reasonable period of time, rather than the time periods imposed for newly executed swaps. The Working Group also argued that events related to the underlying exposure of a swap should not be subject to any confirmation requirement as they are generally addressed in master trading agreements or the applicable confirmation.

Having considered these comments, the Commission has determined not to modify the proposed rule with respect to this issue. In reaching this conclusion, the Commission observes that the definition of ''swap transaction'' would require confirmation of changes to the terms of a swap that have been agreed between the parties or that change the ownership of a swap. However, the definition does not require confirmation of events that may impact the economics of the swap. To the extent that the documented terms of a swap are agreed to in advance and provide for automatic changes to terms upon the occurrence of a defined event, the Commission believes that such change would not require confirmation pursuant to the rule.

13. Legal Uncertainty for Swaps Following Failure to Comply With Swap Confirmation Rules

The proposal did not address the issue of the legal standing or enforceability of a swap transaction that is not confirmed within the time periods mandated by the proposed rules.

In respect of this issue, the FHLBs commented that such failure should not affect the enforceability of the swaps because such an outcome would lead to legal uncertainty in the swap market, and The Working Group recommended that the Commission clearly indicate the regulatory and legal consequences of one or more parties to a swap failing to meet the timing requirements for acknowledgement and confirmation, asserting its view that a swap should not be invalidated for the failure to meet the timing requirements of the proposed rules.

MFA also argued that legal certainty of trade execution is vital for all market participants and the proposed rules may lead to uncertainty as to the enforceability of transactions that fail to be confirmed in compliance with the requirements of the proposed rules. To avoid this result, MFA recommended that the rule be revised to require only that an SD or MSP deliver an acknowledgement specifying the primary economic terms of a swap (rather than all terms), and specify no timeframe for confirmation.

Recognizing the concerns raised by commenters with respect to legal certainty, the Commission notes that it is not the intent of the confirmation rule to provide swap counterparties with a basis for voiding or rescinding a swap transaction based solely on the failure of the parties to confirm the swap transaction in compliance with the proposed rules. In the absence of fraud, the Commission will consider an SD or MSP to be in compliance with the confirmation rule if it has complied in good faith with its policies and procedures reasonably designed to comply with the requirements. However, the Commission notes that it does not have the authority to immunize SDs or MSPs from private rights of action for conduct within the scope of section 22 of the CEA, i.e., violations of the CEA.

14. Recordkeeping Requirements for Acknowledgements and Confirmation—§ 23.501(b)

Proposed § 23.501(b) required SDs and MSPs to keep a record of the date and time of transmission of acknowledgements and confirmations, a record of the length of time between acknowledgement and confirmation, and a record of the length of time between execution and confirmation.

Commenting on the proposal, The Working Group recommended that only a time stamp on acknowledgements and confirmations be required as the remainder of the required records in the proposed rules could be determined from the timestamps on these documents. The Working Group also requested that the Commission clarify how the recordkeeping requirements in the proposed confirmation rule apply to lifecycle events because timestamps for some lifecycle events would not make sense.

MarkitSERV recommended that the Commission clarify that an SD's or MSP's recordkeeping requirements may be delegated to a third-party confirmation platform and the conditions under which such delegation may be done.

BGA argued that energy commodity traders place orders with broker/dealers and may be unaware of the time at which a trade is actually executed, and unable to keep accurate records of the length of time between execution and confirmation of a swap. BGA therefore recommended that the Commission remove the recordkeeping requirements from the proposed rules.

GFED commented that the time stamp requirements of the proposed recordkeeping rules would require significant technology investment as current systems typically do not time stamp at issuance or receipt.

Having considered these comments, the Commission is modifying the recordkeeping requirement. First, the Commission is removing the requirement that SDs and MSPs keep records of the length of time between the acknowledgment and confirmation of a swap, as well as the time between execution and confirmation, as this information can be readily ascertained by reviewing other records. Second, the cross-reference to § 1.31 has been changed to refer to the record retention rule applicable to SDs and MSPs, § 23.203. Apart from these modifications, the Commission believes the records required to be made and maintained under § 23.501(b) are the minimum necessary to monitor compliance with the rule. In addition, the Commission notes that certain items in the recordkeeping requirement is information that will be required for compliance with other Commission rules, such as the time of execution for real-time public reporting of pricing and transaction data and for reporting to an SDR.

In response to MarkitSERV, the rule does not prohibit SDs and MSPs from relying on third-party service providers to achieve compliance with the rule, although the responsibility for compliance cannot be delegated. Finally, in response to The Working Group's comment, the Commission is not persuaded that it is impossible to keep time-stamped records of key changes in ownership including such significant events as execution, termination, assignment, novation, exchange, transfer, amendment, conveyance, or extinguishing of rights or obligations. The Commission believes that its clarification of the ''swap transaction'' definition above alleviates any concern that the rule imposes an impossible recordkeeping requirement.

E. Portfolio Reconciliation—§ 23.502

Portfolio reconciliation is a post-execution processing and risk management technique that is designed to: (i) Identify and resolve discrepancies between the counterparties with regard to the terms of a swap either immediately after execution or during the life of the swap; (ii) ensure effective confirmation of all the terms of the swap; and (iii) identify and resolve discrepancies between the counterparties regarding the valuation of the swap. In some instances, portfolio reconciliation also may facilitate the identification and resolution of discrepancies between the counterparties with regard to valuations of collateral held as margin. Accordingly, in the Confirmation NPRM, the Commission proposed § 23.502, which required SDs and MSPs to reconcile their swap portfolios with one another and provide counterparties who are not registered as SDs or MSPs with regular opportunities for portfolio reconciliation. In order for the marketplace to realize the full risk reduction benefits of portfolio reconciliation, the Commission also proposed to expand portfolio reconciliation to all transactions, whether collateralized or uncollateralized. For the swap market to operate efficiently and to reduce systemic risk, the Commission believed that portfolio reconciliation should be a proactive process that delivers a consolidated view of counterparty exposure down to the transaction level. By identifying and managing mismatches in key economic terms and valuation for individual transactions across an entire portfolio, the Commission's proposal sought to require a process in which overall risk can be identified and reduced. The Commission received numerous comments to the portfolio reconciliation proposal and considered each in formulating the final rules, as discussed below.

1. Statutory Basis for Portfolio Reconciliation

The proposed portfolio reconciliation regulations were proposed pursuant to section 4s(i) of the CEA, as added by section 731 of the Dodd-Frank Act, which directs the Commission to prescribe regulations for the timely and accurate confirmation, processing, netting, documentation, and valuation of all swaps entered into by SDs and MSPs.

The Working Group commented that the Commission should delete the reconciliation requirements from the proposed rule because section 731 of the Dodd-Frank Act does not require the Commission to issue rules on portfolio reconciliation and the Commission has not fully analyzed the potential effect on the market.

In response to The Working Group's comment, the Commission notes that portfolio reconciliation involves both confirmation and valuation and serves as a mechanism to ensure accurate documentation. Thus, the reconciliation requirements finalized herein are within the scope of section 4s(i) of the CEA. Moreover, the Commission reiterates its statement in the Confirmation NPRM that disputes related to confirming the terms of a swap, as well as swap valuation disputes impacting margin payments, have long been recognized as a significant problem in the OTC derivatives market, and portfolio reconciliation is considered an effective means of identifying and resolving these disputes.

2. General Comments to Portfolio Reconciliation—§ 23.502

Proposed § 23.502 required SDs and MSPs to engage in periodic swap portfolio reconciliation with their swap counterparties. Swap portfolio reconciliation is defined in the proposed rule as a process by which the two parties to one or more swaps: (i) Exchange the terms of all swaps in the portfolio between the parties; (ii) exchange each party's valuation of each swap in a portfolio between the parties as of the close of business on the immediately preceding business day; and (iii) resolve any discrepancy in material terms and valuations.

While Chris Barnard supported the proposed reconciliation requirements, several commenters objected to certain aspects of the rule.

GFED commented that the portfolio reconciliation requirements are likely to be onerous, require significant investment in new infrastructure, and have few benefits for shorter dated FX swaps. GFED therefore recommended that the rules require only: (i) Reconciliation of portfolio valuations (as opposed to differences in valuation or trade specifics at the transaction level) because there is existing market infrastructure in place for this purpose; and (ii) reconciliation on a weekly basis with longer timeframes for resolving discrepancies that reflect the global nature of the FX market.

MFA stated that current market practice is for market participants to engage in portfolio reconciliation at the transactional level only if there are portfolio-level discrepancies that result in margin disputes, and MFA recommended that the Commission only require portfolio reconciliation upon the occurrence of a material dispute regarding margin to avoid unnecessary expense. MFA also believes the Commission should accommodate participants with differing policies, procedures, business models, structures, and types of swaps by providing general principles and guidelines as to what constitutes best practices, but not prescriptive rules.

ISDA stated that current portfolio reconciliation processes in the industry are a means of identifying the source of a material collateral dispute at the portfolio level. ISDA believes the draft 2011 Convention on Portfolio Reconciliation and the Investigation of Disputed Margin Calls and the draft 2011 Formal Market Polling Procedure, developed pursuant to industry commitments to the ODSG, which ISDA believes will be widely adopted by OTC derivatives market participants, should play a more significant role in shaping the proposed reconciliation rules. Specifically, ISDA believes that portfolio reconciliation should be defined by reference to generally-accepted industry standards, as instituted through the ODSG process, and reflected in data standards and best practices as published by ISDA.

While TriOptima supports the regular reconciliation of all portfolios and believes that this will identify issues that can minimize counterparty credit exposure and operational risk, TriOptima also believes that the Commission should not require registrants to agree on reconciliation procedures, but should encourage the use of industry-wide practices and protocols.

The Commission has not modified the rule based on these comments, but certain elements of the rule have been modified based on specific comments received, as discussed below. The Commission believes that regular portfolio reconciliation will prevent most disputes from arising and therefore does not recommend that portfolio reconciliation be performed only on an ad hoc basis in response to a material margin dispute at the portfolio level. The Commission notes that portfolio reconciliation is not required for cleared swaps where the DCO holds the definitive record of the trade and determines a binding daily valuation for each swap cleared by the DCO. Therefore the Commission believes that portfolio reconciliation will become less burdensome as the bilateral portfolios of SDs and MSPs become significantly smaller over time as a result of required clearing of swaps. In addition, the need for portfolio reconciliation may be obviated at such time as all swaps are reported to SDRs. For example, if an SDR record of a swap is, by agreement of the parties, the legally operative documentation of the swap, the parties need only consult the SDR record to reconcile their portfolios.[34]

3. Reconciliation of Material Terms—§ 23.502(a)(4) & (b)(4)

The proposed regulations required SDs and MSPs to resolve any discrepancy in material terms of swaps in a swap portfolio discovered during the process of portfolio reconciliation.

Commenting on this aspect of the proposal, ISDA stated that current portfolio reconciliation processes in the industry are not meant to resolve swap terms that do not lead to a material collateral dispute and that the proposed rule would cause reconciliation to become a replacement for the confirmation process. Similarly, The Working Group stated that the Commission should not require reconciliation of terms other than valuations to avoid imposing substantial costs on market participants in the absence of any immediate need.

MarkitSERV asserted that the purpose of portfolio reconciliation is the resolution of disputes that materially impact collateralization at the portfolio level, and thus it is unnecessarily burdensome to require any discrepancy in material terms to be resolved. MarkitSERV recommended that the Commission only require reconciliation of terms that could have a material impact on the valuation or collateralization of a swap.

The FHLBs commented that it is not necessary to repeatedly reconcile all terms of swaps that have been reported to a SDR as most if not all such terms will not change from day-to-day or even month-to-month. The FHLBs believe that SDRs will be in the best position to efficiently and effectively detect and manage discrepancies in the material terms of a swap transaction. Likewise, MetLife recommended that the Commission revise the proposed reconciliation rule to require only the reconciliation of variable economic terms, as the repeated review of static terms confirmed during the confirmation process would be an undue burden and expense.

TriOptima, on the other hand, recognized that the Commission's proposal focuses on reconciliation of *material* terms in portfolios. TriOptima believes that this is appropriate because the priority in reconciliation is on completeness of trade population, rather than granularity in trade details.

Having considered these comments, the Commission is not making any change to the proposed requirement that all discrepancies in material terms be resolved. The Commission is not persuaded by commenters that a discrepancy in the terms of individual swaps would not be material to the swap portfolio as a whole unless such discrepancies impact collateralization at the portfolio level. Rather, the Commission believes that a discrepancy in the material terms of a swap indicates a failure in the confirmation process or a failure in a trade input or processing system. As noted in the preamble to the proposed rules, the Commission believes that the requirement that all swaps be reported to an SDR will reduce the burden imposed by the rule by facilitating efficient, electronic reconciliation for SDs, MSPs, and their counterparties. Accordingly, the two requirements are consistent and mutually reinforcing.

4. Frequency of Portfolio Reconciliation—§ 23.502(b)

Proposed § 23.502(b) required SDs and MSPs to reconcile swap portfolios with other SDs or MSPs with the following frequency: Daily for portfolios consisting of 300 or more swaps, at least weekly for portfolios consisting of 50 to 300 swaps, and at least quarterly for portfolios consisting of fewer than 50 swaps. For portfolios with counterparties other than SDs or MSPs, the proposed regulations required SDs and MSPs to establish policies and procedures for reconciling swap portfolios: Daily for swap portfolios consisting of 500 or more swaps, weekly for portfolios consisting of more than 100 but fewer than 500 swaps, and at least quarterly for portfolios consisting of fewer than 100 swaps.

Several commenters supported the frequency of reconciliation required by the proposed rule. Chris Barnard supported the frequency of the proposed reconciliation requirements, while TriOptima stated that a large number of SDs and MSPs already regularly reconcile their portfolios with each other and with other entities and that the increased frequency and inclusion of smaller portfolios as proposed should prove no obstacle to such entities.

However, several commenters recommended alternatives. ISDA recommended that the Commission accept the portfolio size/frequency gradation established by the ODSG process, as that may change over time, which ISDA believes provides an internationally consistent and flexible standard. ISDA does not believe the proposed rule should distinguish between counterparty types for determining frequency of reconciliation because transaction population is an adequate guide. The Working Group argued that the frequency of portfolio reconciliation should be left up to the counterparties because they have the sophistication necessary to determine whether and with what frequency reconciliation is required in their own circumstances, which may be daily, weekly, upon discovery of a dispute, or not at all. In the alternative, The Working Group recommended that portfolio reconciliation be required quarterly with any counterparty with which a registrant has more than 100 swaps, and annually with all other

[34] For example, DTCC's Trade Information Warehouse maintains the centralized global electronic database for virtually all CDS contracts outstanding in the marketplace. The repository maintains the most current credit default swap contract details on the official legal, or gold record, for both cleared and bilateral CDS transactions.

counterparties. Finally, Chatham recommended that the Commission revise the proposed rules to provide that reconciliation with end users is only required for swaps with maturities greater than one year and at the following frequency: Weekly for portfolios of 500 or more swaps; quarterly for portfolios of 100 to 500 swaps; annually for portfolios of 50 to 100 swaps; and optional reconciliation for portfolios of 50 or less swaps.

Still other commenters objected more generally to the required frequency of reconciliation. Dominion argued that the rule should not override any contractual right that end users may have regarding reconciliation, including frequency and the process for resolving disputes, while AMG argued that reconciliation required under the proposed rules is unnecessarily frequent and imposes excessive costs that do not bear a reasonable relationship to the systemic risk goals of the Dodd-Frank Act.

Finally, the OCC stated that many SDs will not be among the G–14 largest OTC derivatives dealers and, given the incremental progression that was necessary for the G–14 OTC derivatives dealers to develop the infrastructure necessary to increase reconciliation amongst themselves from weekly reconciliation for portfolios with 5,000 or more trades in 2008 to the current daily reconciliation for portfolios of 500 or more trades, the Commission should provide sufficient time for all registrants to develop required infrastructure.

Having considered these comments, the Commission is modifying the proposed rule to require daily reconciliation of swap portfolios among SDs and MSPs only for swap portfolios of 500 or more swaps. The Commission continues to believe that the requirement that all swaps be reported to an SDR will lead to efficient, electronic reconciliation for SDs and MSPs, but, at the urging of commenters, has reduced the required frequency of reconciliation to match the frequency of reconciliation currently undertaken by the largest prospective SDs.[35] In addition, the daily reconciliation requirement for swap portfolios among SDs and MSPs of 500 or more swaps brings the rule into conformance with international regulatory efforts.[36]

For portfolios with counterparties other than SDs or MSPs, the Commission is adopting the recommendation proposed by The Working Group—that portfolio reconciliation be required quarterly with any counterparty with which a registrant has more than 100 swaps, and annually with all other counterparties. The Commission believes this approach is largely consistent with that recommended by Chatham, and it responds, in part, to concerns expressed by AMG. The Commission believes it also will serve to lower the costs of the rule. Despite this change in the frequency of reconciliation required for portfolios with non-SD, non-MSP counterparties, the Commission reiterates its belief that periodic reconciliation with all counterparties is a best practice for those using swaps.

In response to Dominion's concern about the rule overriding contractual rights of market participants, the Commission wishes to clarify that parties are free to negotiate and elect whatever dispute resolution mechanisms they so choose. The reconciliation rule merely sets forth the minimum requirements and timing for reconciliation of swap portfolios. The rule is not intended to override contractual rights so long as SDs and MSPs are in compliance with these limited provisions.

5. Exchange of Swap Data for Portfolio Reconciliation—§ 23.500(i) & § 23.502(b)

The preamble to the proposed regulations stated that portfolio reconciliation could consist of one party reviewing the trade details and valuations delivered by the other party and either affirming or objecting to such details and valuations. MarkitSERV recommended that the Commission clarify the circumstances in which both parties would be required to exchange swap data and circumstances in which only one party would be required to send swap data to its counterparty for verification. Consistent with its prior statement, the Commission prefers to permit maximum flexibility and innovation in the process and thus will leave the circumstances of exchange or verification to the discretion of SDs, MSPs, and their counterparties.

6. Portfolio Reconciliation With Non-SDs/MSPs—§ 23.502

The proposed regulation required SDs and MSPs to establish written policies and procedures for engaging in portfolio reconciliation with non-SDs and non-MSPs, which includes the reconciliation of valuations for each swap in the parties' portfolio.

Commenting on the proposal, MarkitSERV stated that buy-side firms view valuation data as private information. To allow for confidentiality, MarkitSERV recommends that the Commission permit non-SDs and non-MSPs to perform portfolio reconciliation via third parties in a process that would only disclose valuation data when a discrepancy exceeds the threshold set forth in the proposed rules.

Dominion asserted that section 4s(i) of the CEA required the Commission to adopt regulations for netting and valuation for SDs and MSPs, but not end users, and objects that the proposed rules require SDs and MSPs to establish policies for reconciliation with end users and for resolution of valuation disputes with end users in a timely fashion. Dominion is concerned that an end user will be required to provide SDs with proprietary market valuations that could be used against the interests of the end user. Dominion therefore recommended that the Commission clarify that an SD's or MSP's written procedures may not require end users to disclose any proprietary market information for purposes of dispute resolution.

The FHLBs argued that end users should not be subject to the same reconciliation requirements as SDs and MSPs because the swap portfolios of end users do not pose a significant risk to the overall financial system and the reconciliation requirements may increase the costs of swaps for end users. Chatham similarly argued that non-SDs and non-MSPs using swaps to hedge risk do not pose systemic risk so daily or weekly reconciliation is not necessary.

As discussed above, the Commission is modifying the proposed rule to change the word ''enforce'' to ''follow.'' Based on commenters' concerns that an SD or MSP cannot force a non-registrant to abide by the portfolio reconciliation requirements, the Commission is further modifying the proposed rule to require

[35] In December 2008, the ODSG's group of 14 major dealers committed to execute daily portfolio reconciliations for collateralized portfolios in excess of 500 trades between participating dealers by June of 2009. *See* June 2, 2009 summary of industry commitments, available at *http://www.isda.org/c_and_a/pdf/060209table.pdf*. As of May 2009, all participating dealers were satisfying this commitment. The ODSG dealers expanded their portfolio reconciliation commitment in March 2010 to include monthly reconciliation of collateralized portfolios in excess of 1,000 trades with any counterparty.

[36] Compare with ESMA Draft Technical Standards, Article 2 RM, subsection 4, (stating that ''In order to identify at an early stage, any discrepancy in a material term of the OTC derivative contract, including its valuation, the portfolio reconciliation shall be performed: * * * each business day when the counterparties have 500 or more OTC derivative contracts outstanding with each other; * * * once per month for a portfolio of fewer than 300 OTC derivative contracts outstanding with a counterparty; * * * once per week for a portfolio between 300 and 499 OTC derivative contracts outstanding with a counterparty.'')

only that SDs and MSPs establish policies and procedures reasonably designed to ensure that they engage in portfolio reconciliation with non-registrants with the modified frequency discussed above. The Commission believes that ''reasonably designed to ensure'' is not the same as requiring a guarantee of compliance. Therefore, the Commission believes that the rule, as modified, would require that the SDs and MSPs make reasonable efforts to engage in portfolio reconciliation with non-registrants, but would not give SDs or MSPs the authority to require it of their non-registrant counterparties.

In addition, the Commission is modifying the proposed rule to clarify that discrepancies in material terms or valuation disputes that become known to the parties before the quarterly or annual reconciliation with non-SDs, non-MSPs, should be resolved in a timely fashion. With this change, the Commission notes that non-SD, non-MSP counterparties may bring a discrepancy or dispute to an SD's or MSP's attention and the SD or MSP counterparty must work to resolve those identified discrepancies and disputes.

7. Portfolio Reconciliation With DCOs for Cleared Swaps—§ 23.502(c)

The proposed regulations stated that the portfolio reconciliation requirements will not apply to swaps cleared by a DCO.

With respect to this provision, MarkitSERV recommended that the Commission require SDs and MSPs to regularly reconcile their positions in cleared swaps against SDRs, DCOs, and clearing brokers to correct discrepancies between the DCO record and a firm's internal records.

The Commission has determined not to follow MarkitSERV's recommendation on this point. DCOs maintain the definitive record of the positions of each of their clearing members (both house and customer) and mark those positions to a settlement price at least once a day.[37] Accordingly, the Commission believes that cleared swaps do not present the same documentation and valuation issues that uncleared swaps do. The Commission notes that reconciliation of swap data between DCOs and SDRs is beyond the scope of this rulemaking, which is adopting regulations with respect to SDs and MSPs only.

[37] Under typical DCO rules, clearing members are bound by the settlement price of the DCO and the product specifications of cleared swaps are set by the DCO.

8. Portfolio Reconciliation by ''Qualified Third Parties''—§ 23.502(b)

The proposed regulations permitted portfolio reconciliation to be performed on behalf of SDs, MSPs, and their counterparties by a qualified third party.

Commenting on this proposal, ABC & CIEBA and AMG separately recommended that the Commission not require use of ''qualified'' third parties for portfolio reconciliation, but, rather should explicitly require that use of any third party service provider must be agreed by both parties and recognize that each party may use a different third party for reconciliation. Specifically, ABC & CIEBA recommended that § 23.502(b)(1) and (2) be revised to read as follows:

''(1) Each swap dealer or major swap participant shall agree in writing with each of its counterparties on the terms of the portfolio reconciliation, including agreement on the selection of any third party.

(2) The portfolio reconciliation may be performed on a bilateral basis by the counterparties or by one or more third parties selected by the counterparties in accordance with § 23.502(b)(1).''

In response to these comments, the Commission is modifying the proposed rule to delete the word ''qualified,'' to require that the use of a third-party service provider be subject to agreement of the parties, and to provide that each party may use a different third party so long as the provisions of the rule are met. Further, per AMG's comments, the Commission expects that parties will determine if the third-party is qualified based on their own policies.

9. Reconciliation Discrepancy Resolution Procedures—§ 23.502(b)(4)

The proposed regulations required that SDs and MSPs establish procedures reasonably designed to resolve any discrepancies in the material terms or valuation of each swap identified in the portfolio reconciliation process.

Commenting on this aspect of the proposal, ABC & CIEBA recommended that the Commission revise § 23.502(b)(4) in order to ensure that reconciliation dispute resolution by SDs and MSPs is fair, impartial, and even-handed.

The Commission agrees that reconciliation dispute resolution should be fair, impartial, and even-handed as recommended by ABC & CIEBA, but believes that the commenter's concern will be addressed by deleting the word ''enforce'' as discussed above. The Commission expects that SDs and MSPs will cooperate with their counterparties and any applicable third-party service provider in resolving discrepancies brought to light through portfolio reconciliation.

10. Time Period for Resolution of Discrepancies in Material Terms—§ 23.502(a)(4) & (b)(4)

With regard to portfolio reconciliation among SDs and MSPs, the proposed regulations required that any discrepancy in material terms be resolved immediately.

Freddie Mac stated that in some cases it may be impossible to resolve a discrepancy in material terms immediately, as required under § 23.502(a)(4). Freddie Mac recommended that the Commission should revise the proposed rules to provide that the timely and accurate processing and valuation requirements of the Dodd-Frank Act will be deemed satisfied whenever swaps are subject to a master netting agreement and collateral pledge agreement under which the parties mark net portfolio value to market and exchange collateral on the basis of such valuation as promptly as commercially reasonable.

Having considered Freddie Mac's comment, the Commission is adopting the rule as proposed with respect to immediate resolution of discrepancies in material terms in swaps among SDs and MSPs. Given the timely confirmation requirements of all terms of a swap as established under § 23.501, the Commission believes an immediate resolution of any material term discrepancy is appropriate. Additionally, the Commission believes that a longer period is not justified because resolution of a discrepancy in a material term will likely require an amendment of the trade record in the relevant SDR, which, for regulatory oversight purposes, should be as accurate as possible.

11. Resolution of Valuation Disputes in Portfolio Reconciliation—§ 23.502(a)(5) & (b)(4)

With regard to portfolio reconciliation among SDs and MSPs, the proposed regulations required that any discrepancy in the valuation of a swap be resolved within one business day. With regard to portfolio reconciliation between SDs or MSPs and non-registrants, the proposed regulations required that SDs and MSPs have policies and procedures reasonably designed to resolve any discrepancy in the valuation of a swap in a timely fashion.

With respect to this aspect of the proposal, ISDA commented that parties to a good-faith dispute should have a commercially reasonable timeframe in which to consult in order to find an appropriate resolution of the dispute. ISDA believes the draft 2011 Convention on Portfolio Reconciliation and the Investigation of Disputed Margin Calls and the draft 2011 Formal Market Polling Procedure, developed pursuant to industry commitments to the ODSG, which ISDA believes will be widely adopted by OTC derivatives market participants, should play a more significant role in shaping the proposed reconciliation rules. The Working Group, the FHLBs, and AMG also recommended that the Commission support the valuation dispute resolution methodology sponsored by ISDA.

In addition to its general comments, ISDA made specific recommendations:

• Resolution is labor intensive and to avoid undue costs, discrepancies in terms and valuations should only require resolution if such are causing material portfolio-level collateral transfer disputes, rather than on a transaction by transaction basis, as it allows for the possibility that material but offsetting differences may exist in a portfolio.

• Again to avoid undue costs, a materiality standard should apply to any mandated resolution requirement, because, in the absence of a collateralization requirement or a live dispute as to collateralization, discrepancies in valuation may be allowed to subsist as potentially harmless and may disappear through changes in portfolio composition over time. ISDA recommends that the ODSG resolution tolerances be adopted by the Commission, as such tolerances may be amended over time.

• Resolution of a valuation dispute should mean that the discrepancy in a portfolio-level margin dispute is reduced such that it is within the applicable resolution tolerance, rather than requiring exact agreement.

• Resolution of a valuation dispute should not require parties to make adjustments to their books and records.

• Parties should be free to agree to accept that there is a difference in opinion as to value, so long as appropriate capital is held against any potential collateral shortfall.

With respect to the proposal to require valuation disputes to be resolved within one business day, ISDA stated that a one-day timeframe for resolution of valuation discrepancies is infeasible, especially when applied to parties across vastly different global time zones, due to the need to analyze reconciliation results, escalate for trader-to-trader discussion or to senior management. Further, ISDA argued that some disputes prove to be intractable and must be resolved through a market poll, which requires time to build and populate a valuation model, which may take hours or even days. AMG also argued that the time periods are unnecessarily short and do not bear a reasonable relationship to the systemic risk goals of the Dodd-Frank Act, noting that the time periods are not consistent with recent ISDA dispute resolution protocols or other methodologies incorporated in master agreements, and could impose excessive costs on swap market participants.

AMG recommended that the Commission clarify the consequences of failing to resolve a valuation dispute within the mandated timeframe. Freddie Mac stated that in some cases it may be impossible to resolve a discrepancy in valuation within one business day, while BGA does not believe that registrants should be penalized for failing to meet the one business day resolution deadline. BGA argued that (i) SDs and MSPs do not have control over their counterparties so resolution may take more than a day; and (ii) a hard deadline may disadvantage SDs and MSPs in negotiating a resolution with a counterparty that is not subject to a deadline. Finally, The Working Group argued that the proposed requirement that valuation disputes between registrants be resolved within one business day is not workable due to the complex calculations required, involvement of multiple functional groups within a registrant, and possibility that resolution of a dispute may require modifications to a valuation model that could create further discrepancies for other swaps that are valued using the same model. The Working Group believes the Commission should require only that registrants begin the valuation dispute resolution process upon discovery of a dispute, but permit counterparties to resolve the dispute within a reasonable time period.

The FHLBs requested that the Commission specify the meaning of ''in a timely fashion'' as it relates to discrepancy resolution with end users.

The Working Group also had a number of recommendations with respect to the proposed rule:

• The Commission should not adopt valuation dispute resolution rules that may be burdensome for markets where no problem exists, such as swap markets with underlying physical markets that provide an objective basis for swap valuations.

• The proposed reconciliation rules should apply only to valuation disputes on a portfolio basis, and not on a transaction basis, as it would be unnecessarily burdensome to analyze the valuation of individual swaps unless there is a material dispute as to the portfolio level exposure between the parties.

• Parties should have the right to continue to exchange collateral without resolving a discrepancy exceeding 10 percent if they conclude that the discrepancy is not material in their particular circumstances.

With respect to the proposed 10 percent threshold before a dispute would require resolution, Chatham argued that a percentage threshold of 10 percent difference is insufficient because it will impose a significant burden in cases where the absolute value of the swap is small, such as just after a swap is executed and in the period just before maturity. MFA also recommended that the Commission revise the proposed rule to provide that a valuation discrepancy must not only exceed 10 percent, but must also exceed some reasonable dollar threshold, and must result in one party being unwilling to satisfy a collateral call from the other party. On the other hand, MetLife supported the 10 percent buffer for designation of valuation discrepancies, but recommended that the Commission extend the deadline for valuation dispute resolution from 1 to at least 3 business days with respect to highly structured and customized swaps.

TriOptima provided context with respect to valuation dispute resolution in the swaps market. TriOptima commented that swaps are valued using internal models, which use inputs derived from observable sources or internal calculations and reflect a party's view on the market; that for many swaps, there is only sparse or episodic liquidity in similar contracts, which can be used to calibrate internal valuation models; and that there is valuable information for regulators in a spectrum of differing valuations of a swap. As an example, TriOptima hypothesized that regulators could have had an early warning sign in the run up to the 2008 financial crisis when some market participants realized earlier than others that the price of credit risk was too low and raised the price in their internal valuations as opposed to counterparties that did not recognize the change in credit risk. With respect to the proposal, TriOptima argued that forcing convergence on swap valuations between parties could be detrimental to the stability and resilience of the financial system by creating a disincentive for firms to use their own judgment in setting market values, removing a valuable diagnostic tool for regulators. TriOptima further stated that there is a difference between an internal valuation used for regulatory capital purposes and a valuation agreed with a counterparty for use in calculating margin. If the agreed valuation is lower than the internal valuation, a party must reserve capital for the unsecured exposure. Therefore, TriOptima argued that if the Commission requires the parties to agree on a valuation for internal purposes, the unsecured exposure disappears and less capital will be reserved, reducing stability and resilience in the financial markets. TriOptima recommended that the Commission focus on establishing principles for how to determine the margining amount on a portfolio level, rather than forcing parties to agree on valuation of individual transactions, with a key element in such principles being consistency. For valuation differences that persist after excluding errors and inconsistencies, TriOptima believes the parties should be allowed to agree to disagree and face the credit risk and capital consequences of having unsecured exposures.

The Commission recognizes the view that there is valuable information for market participants and regulators in a spectrum of differing valuations of a swap. The Commission also is cognizant of the ongoing efforts by industry and ISDA to improve the existing valuation dispute resolution process. Based on meetings between Commission staff and ISDA's Collateral Steering Committee, the Commission understands that ISDA's draft 2011 Convention on Portfolio Reconciliation and the Investigation of Disputed Margin Calls and the draft 2011 Formal Market Polling Procedure has reduced valuation dispute resolution to a 30-day process.

Issues related to swap valuations are woven through a number of Commission rule proposals. For instance, § 23.504(e), as adopted in this release, requires SDs and MSPs to report valuation disputes in excess of $20,000,000 lasting longer than three business days to the Commission, while under § 23.504(b)(4) SDs and MSPs are required to agree on valuation methodologies with their counterparties. The Commission believes that by requiring agreement with each counterparty on the methods and inputs for valuation of each swap, it is expected that § 23.504(b)(4) will assist SDs and MSPs to resolve valuation disputes in a timely manner, thereby reducing risk.

Agreement between SDs, MSPs, and their counterparties on the proper daily valuation of the swaps in their swap portfolio also is essential for the Commission's margin proposal. As discussed above, under proposed rule § 23.151, non-bank SDs and MSPs must document the process by which they will arrive at a valuation for each swap for the purpose of collecting initial and variation margin. All non-bank SDs and MSPs must collect variation margin from their non-bank SD, MSP, and financial entity counterparties for uncleared swaps on a daily basis. Variation margin requires a daily valuation for each swap. For swaps between non-bank SDs and MSPs and non-financial entities, no margin is required to be exchanged under Commission regulation, but the non-bank SDs and MSPs must calculate a hypothetical variation margin requirement for each uncleared swap for risk management purposes under proposed § 23.154(b)(6).

Given that arriving at a daily valuation is one of the building blocks for the margin rules and is essential for the mitigation of risk posed by swaps, the Commission expects that SDs and MSPs as a matter of best practice will work to resolve valuation disputes for swaps with other SDs and MSPs within one business day. However, the Commission is modifying this provision to require that valuation disputes be subject to policies and procedures reasonably designed to ensure that such disputes are resolved within five business days, as discussed further below. The Commission has determined to make no change to the requirement that valuation disputes between SDs, MSPs, and non-SDs or non-MSPs be subject to policies and procedures reasonably designed to ensure that such disputes are resolved ''in a timely fashion.''

The Commission is persuaded by commenters that some valuation disputes may be difficult to resolve within the one-day timeframe and is therefore modifying the rule such that it no longer requires resolution, but instead requires that SDs and MSPs establish procedures reasonably designed to ensure that swap valuation disputes are resolved within five business days.[38] Thus SDs and MSPs will not violate the rule if they fail to resolve a particular dispute within five business days, so long as they have followed their reasonably designed procedures. In addition, the rule will require SDs and MSPs to have policies and procedures identifying how they will comply with any variation margin requirements pending resolution of a valuation dispute. The rule already requires SDs and MSPs to establish procedures to resolve valuation disputes with non-SD/MSP counterparties in a timely fashion.

Regarding the safe harbor for valuation differences of less than 10 percent, the Commission believes the 10 percent threshold is appropriate as it provides certainty as to which disputes must be resolved. The Commission believes the efficiency of a bright line rule, as opposed to the formulas and discretion in the alternatives presented by commenters, will better serve the operational processes of SDs and MSPs and the regulatory oversight of the Commission.

12. Reporting of Valuation Disputes to the Commission

The proposed regulations required SDs and MSPs to keep records of valuation disputes and the time to resolution of such disputes, but did not require SDs or MSPs to report such disputes to the Commission. However, as noted by the New York City Bar Committee on Futures and Derivatives (NYCB), proposed § 23.504(e) required valuation disputes among SDs and MSPs outstanding for more than one business day, or five business days for disputes between an SD or MSP and a non-SD, non-MSP counterparty to be reported to the Commission.

In this regard, ISDA recommended that the Commission require monthly reporting of margin disputes outstanding more than 15 days that exceed the applicable tolerances, which is consistent with current ODSG commitments. MetLife recommended a period of 90 days before reporting is required.

As discussed above, the Commission is modifying this provision to require reporting within three business days, and it has added a $20,000,000 threshold for reporting of disputes. The Commission believes the less frequent reporting provided by the threshold will alleviate the concerns of the commenters.[39]

[38] Compare with ESMA Draft Technical Standards, Article 4 RM, subsection 2, (stating that ''counterparties shall, when concluding OTC derivative contracts with each other have agreed detailed procedures and processes in relation to * * * resolution of disputes in a timely manner; * * * resolution of disputes that are not resolved within five business days, including third party arbitration or a market polling mechanism.'')

[39] Compare with ESMA Draft Technical Standards, Article 4 RM, subsection 2, (stating that ''counterparties shall report to the competent authority * * * any disputes between counterparties relating to an OTC derivative contract, its valuation or the exchange of collateral for an amount or a value higher than EUR 15 million and outstanding for at least 15 business days.'')

13. Recordkeeping Requirement for Portfolio Reconciliation—§ 23.502(d)

The proposed regulations required SDs and MSPs to make and retain a record of each portfolio reconciliation, including a record of each discrepancy and the time to resolution of each discrepancy.

ISDA objected to the recordkeeping requirement for portfolio reconciliation, arguing that it should consist only of disputes, and not of the entire process. Specifically, ISDA recommended that records be kept of the date of the initial dispute, the resolution of the dispute, the date of resolution, and the net portfolio valuations of the two parties. Further, ISDA requested an explicit statement that access to third party reconciliation services' records will satisfy the obligation to permit inspection of the records by supervisors. Similarly, The Working Group requested that the Commission clarify that the records required to be kept in relation to valuation dispute resolution pertain only to discrepancies that exceed the 10 percent buffer.

The Commission notes that its recordkeeping rule for SDs and MSPs includes a recordkeeping requirement that SDs and MSPs make and keep a record of each portfolio reconciliation, including the number of portfolio reconciliation discrepancies and the number of swap valuation disputes (including the time-to-resolution of each valuation dispute and the age of outstanding valuation disputes, categorized by transaction and counterparty).[40] In the interests of streamlining regulatory requirements, the Commission is modifying § 23.502(d) to cross reference § 23.202 and delete the substantive requirements. The Commission has also revised the cross-reference to § 1.31 to a cross-reference to the SD and MSP record retention rule, § 23.203.

In response to comments of ISDA and The Working Group, the Commission believes that the level of detail included in portfolio reconciliation records is left to the reasonable discretion of SDs and MSPs so long as the basic requirements of the rule are met.

F. Portfolio Compression—§ 23.503

Section 4s(i) of the CEA directs the Commission to prescribe regulations for the timely and accurate processing and netting of all swaps entered into by swap dealers and major swap participants. Portfolio compression is an important, post-trade processing and netting mechanism that can be an effective and efficient tool for the timely and accurate processing and netting of swaps by market participants. Portfolio compression is a mechanism whereby substantially similar transactions among two or more counterparties are terminated and replaced with a smaller number of transactions of decreased notional value in an effort to reduce the risk, cost, and inefficiency of maintaining unnecessary transactions on the counterparties' books. Because portfolio compression participants are permitted to establish their own credit, market, and cash payment risk tolerances and to establish their own mark-to-market values for the transactions to be compressed, the process does not alter the risk profiles of the individual participants beyond a level acceptable to the participant. The usefulness of portfolio compression as a risk management tool has been acknowledged widely.

In 2008, the PWG identified frequent portfolio compression of outstanding trades as a key policy objective in the effort to strengthen the OTC derivatives market infrastructure.[41] Similarly, the 2010 staff report outlining policy perspectives on OTC derivatives infrastructure issued by the FRBNY identified trade compression as an element of strong risk management and recommended that market participants engage in regular, market-wide portfolio compression exercises.[42]

Based upon these considerations, the Commission proposed § 23.503, which imposed certain portfolio compression requirements upon SDs and MSPs. The Commission received numerous comments to the portfolio compression proposal and considered each in formulating the final rules, as discussed below.

1. Statutory Basis for Portfolio Compression

The proposed portfolio compression regulations were proposed pursuant to section 4s(i) of the CEA, which directs the Commission to prescribe regulations for the timely and accurate confirmation, processing, netting, documentation, and valuation of all swaps entered into by SDs and MSPs.

Commenting on the proposal, ISDA stated that the portfolio compression requirements lack an explicit statutory basis in the Dodd-Frank Act, and should be left to the judgment of market participants. Likewise, The Working Group stated that section 731 of the Dodd-Frank Act does not require the Commission to issue rules on portfolio compression and believes the final rules should not include portfolio compression requirements.

In response to these comments, section 4s(i) of the CEA clearly authorizes the Commission to prescribe standards for the netting of swaps. As explained in the Confirmation NPRM, portfolio compression is a post-trade processing and netting mechanism whereby substantially similar transactions among two or more counterparties are terminated and replaced with a smaller number of transactions of decreased notional value.

2. Definition of ''Multilateral Portfolio Compression Exercise''—§ 23.500(h)

The proposed regulations defined ''multilateral portfolio compression exercise'' as an exercise in which multiple swap counterparties wholly or partially terminate some or all of the swaps outstanding among those counterparties and replace the swaps with a smaller number of swaps whose combined notional value is less than the combined notional value of the original swaps included in the exercise. The replacement swaps may be with the same or different counterparties.

With respect to this definition, TriOptima commented that the proposed definition of ''multilateral portfolio compression exercise'' is too narrow and recommends that the Commission revise the definition to read: ''an exercise in which multiple swap counterparties wholly terminate or change the notional value of some or all of the swaps submitted by the counterparties for inclusion in the portfolio compression and, depending on the methodology employed, replace the terminated swaps with other swaps whose combined notional value (or some other measures of risk) is less than the combined notional value (or some other measure of risk) of the terminated swaps in the compression exercise.'' ISDA recommended the same changes as those recommended by TriOptima for the same reasons.

Based on the explanations of commenters, the Commission is persuaded that the proposed definition was unnecessarily narrow and the Commission has accordingly modified the definition of ''multilateral portfolio compression exercise'' in the manner recommended by commenters. In addition, for the sake of consistency, the

[40] *See* 17 CFR 23.202(a)(3)(iii), Reporting, Recordkeeping, and Daily Trading Records Requirements for Swap Dealers and Major Swap Participants, 77 FR 20128, 20201 (April 3, 2012).

[41] *See* ''Policy Objectives for the OTC Derivatives Markets,'' President's Working Group on Financial Markets (Nov. 14, 2008).

[42] *See* Federal Reserve Bank of New York Staff Report No. 424: ''Policy Perspectives on OTC Derivatives Market Infrastructure,'' Jan. 2010 (revised Mar. 2010).

definition of ''bilateral portfolio compression exercise'' has also been modified in a consistent manner.

3. Mandatory Portfolio Compression—§ 23.503

The proposed regulations required SDs and MSPs to engage in bilateral and multilateral portfolio compression exercises with respect to all swaps in which their counterparty is also an SD or MSP. In contrast, the proposed regulations required SDs and MSPs to establish policies and procedures for engaging in portfolio compression with swap counterparties that are not SDs or MSPs.

On this issue, The Working Group argued that portfolio compression is only beneficial in markets where there is a high degree of transaction standardization and a high volume of redundant trades, and therefore recommended that the Commission only impose mandatory compression exercises on markets where the ratio of gross market value to notional size (which is a rough estimation of the level of redundant trades) shows that the benefits of compression outweigh the substantial cost of engaging in the exercise. The Working Group also recommended that the Commission not impose mandatory compression in markets where compression platforms have not yet been designed, tested, and approved by the Commission.

Markit pointed out that portfolio compression was recently attempted in the commodities and foreign exchange asset classes, but was not pursued further because the trial cycles had limited success, and is concerned that mandatory participation under the proposed rules might lead to compression for a range of uncleared swaps where the potential benefits do not justify the cost of the exercise, particularly for the large number of potential SDs and MSPs that currently do not participate in compression cycles. Costs identified by Markit include changes to participant's risk systems and connectivity enhancements that would allow for the booking and processing of a large volume of swaps (thousands) in as short a period as a single day. Markit recommended an alternative to the proposal in which the Commission would establish thresholds for determining whether a category of non-cleared swaps should be subject to any mandatory compression exercise and the frequency of such exercises. Markit believes such thresholds should be related to the minimum number of swaps, number of participants, number of swaps per participant, amount of ongoing trading activity, degree of standardization in the product, and the notional amount of transactions that must be compressed.

With respect to compression between SDs and MSPs and non-SDs, non-MSPs, Markit believes that there will be no noteworthy benefit from requiring non-dealer counterparties to participate in portfolio compression exercises for uncleared swaps, as such entities have portfolios with a very small number of offsetting transactions and often have complicated arrangements with prime brokers making compression more difficult and costly.

Freddie Mac commented that mandatory portfolio compression should be limited to swaps that match and offset cash flows exactly, and that any compression requirement allow for exceptions for end users relying on swaps for hedging purposes or that otherwise believe the termination of an existing swap would have an adverse effect on remaining trades.

Providing the view of a portfolio compression vendor, TriOptima stated that for many smaller institutions and for larger institutions trading illiquid swaps, the net to gross ratio of a portfolio is sometimes close to 100 percent, meaning that all swaps in the portfolio are in the same market-risk direction. TriOptima argued that it would not be productive for such institutions to take part in multilateral compression as many transactions designated as hedges for accounting purposes must be excluded from compression, and either no transactions could be compressed or the resulting notional reduction would be minimal. TriOptima therefore recommended that the Commission remove any mandatory compression requirement from the proposed rule and instead focus on creating incentives for institutions to take part in portfolio compression. TriOptima noted that most capital requirements are based on net risk positions and therefore recommended that the Commission create capital or other incentives to reduce gross risk positions.

Based on the comments received, the Commission has concluded that it may be premature to require SDs and MSPs to engage in mandatory bilateral and multilateral compression exercises for all asset classes at this time. Although the Commission agrees with Markit's comment that compression opportunities should be based on an analysis of the market, including the number of swaps, number of participants, number of swaps per participant, amount of ongoing trading activity, degree of standardization in the product, and the notional amount of transactions that could be compressed, it does not foresee that it will have the resources to make such a determination or to set thresholds for mandatory compression. In addition, as discussed more fully below, the Commission is modifying the bilateral offset requirement for swaps between SDs and MSPs that are ''fully offsetting.''

Accordingly, the Commission has modified the proposed rules to remove the mandatory bilateral and multilateral compression requirements and has replaced them with a requirement that SDs and MSPs establish policies and procedures for periodically engaging in portfolio compression exercises with counterparties that are also SDs or MSPs and for engaging in portfolio compression with all other counterparties upon request.[43] In this regard, the Commission anticipates that in order to be in compliance with the rule, an SD's or MSP's policies and procedures would include procedures for engaging in periodic evaluation of compression opportunities, written policies establishing when the SD or MSP would consider a compression opportunity to be materially beneficial, and procedures for engaging in those opportunities when such arise. These policies and procedures would also be required to address how the SD and MSP would determine which swaps to include and exclude from compression exercises and what risk tolerances it would accept.

The Commission has also modified the rule to clarify that (1) non-SDs/MSPs are not required to engage in portfolio compression exercises with SDs and MSPs, but (2) that SDs and MSPs must engage in portfolio compression exercises with non-SDs/MSPs upon request.

As further support for the modifications, the Commission notes that in the proposed DCO rules, the Commission proposed that DCOs must offer multilateral compression, but the final DCO rule provided that participation in compression exercises by clearing members and their customers would be voluntary.[44]

[43] Compare with ESMA Draft Technical Standards, Article 3 RM, subsection 2, (stating that ''counterparties with 500 or more OTC derivative contracts outstanding which are not centrally cleared shall have procedures to regularly, and at least twice a year, analyse the possibility to conduct a portfolio compression exercise in order to reduce their counterparty credit risk and engage in such portfolio compression exercise.'')

[44] *See* 17 CFR 39.13(h)(4), Derivatives Clearing Organization General Provisions and Core Principles, 76 FR 69334, 69383 (Nov. 8, 2011).

4. Swaps Eligible for Compression—§ 23.503

Proposed § 23.503 required SDs and MSPs to include all swaps in their compression exercises with other SDs and MSPs and swaps with other counterparties to the extent that the swaps are able to be terminated through a portfolio compression exercise.

With respect to this aspect of the proposal, BlackRock recommended that the Commission revise the proposed compression rules to more fully promote the compression of substantially similar, but not fully offsetting, swaps.

The Commission believes that the concerns underlying BlackRock's comment is addressed by the changes to the proposed rule as discussed above, specifically the modification requiring SDs and MSPs to engage in compression with non-SDs and non-MSPs at the request of such parties. The Commission believes it is prudent to permit the parties to agree on the method and venue of compression, rather than having the Commission prescribe the method and venue.

5. Application of Portfolio Compression to Non-SD/MSPs

In the Confirmation NPRM, the Commission requested comment on whether it should require SDs and MSPs to engage in compression exercises with counterparties that are not SDs or MSPs. The Commission also requested comment on whether financial entities as defined in proposed § 23.500 should be subject to the same compression requirements as SDs and MSPs.

In response to this request for comments, Markit stated that there will be no noteworthy benefit from requiring non-dealer counterparties to participate in portfolio compression exercises for uncleared swaps because such entities have portfolios with a very small number of offsetting transactions and often have complicated arrangements with prime brokers making compression more difficult and costly.

ISDA also identified several issues with the proposal to apply compression requirements to non-SDs:

- Current portfolio compression exercises only achieve successful results by limiting exercises to a single asset-class and a relatively small and homogeneous group of participants (i.e., the G14 dealers), which limits the difficulty and range of attendant risks.
- Multilateral compression cycles are typically managed with automated tools to support tear up and new trade creation that end-users usually do not possess, and the costs of obtaining such tools cannot be justified by the benefits.
- The requirement for bilateral netting of swaps not covered by multilateral or cleared compression processes will impose onerous tasks with only limited benefit for end-users who engage in trades that are typically more bespoke.

ABC & CIEBA commented that benefit plans should not be subject to the proposed portfolio compression rule because every swap of a benefit plan serves a business purpose and benefit plan swap portfolios contain no redundant positions. ABC & CIEBA also argued that benefit plans may have multiple investment advisers with individual mandates and portfolio compression could result in losses if market movements that had been previously hedged are undone by compression. ABC & CIEBA thus urged the Commission to require SDs and MSPs to obtain explicit consent of end user counterparties prior to compression of any swap.

AMG, Dominion, the FHLBs, and Chatham echoed the concerns of ABC & CIEBA, commenting that non-SDs and non-MSPs (including financial entities) should not be subject to mandatory or involuntary portfolio compression due to legitimate reasons for offsetting, but beneficial swap positions, such as hedging specific assets. Thus, AMG, Dominion, and the FHLBs recommended that the Commission revise the proposed rules to require SDs and MSPs to obtain the explicit consent of its end user counterparties prior to compression of any swap. BlackRock recommended that the Commission require SDs and MSPs to engage in bilateral and multilateral compression exercises with counterparties that are not SDs or MSPs, if such parties chose to do so.

MFA similarly recommended that portfolio compression be an option for end users, but not an obligation as portfolio compression is only appropriate for entities with portfolios large enough to yield meaningful benefits that outweigh the expense of a compression exercise. MFA further stated that end users should not be required to engage in multilateral portfolio compression for cleared swaps. GFED believes that portfolio compression is unnecessary for non-dealer end users as volumes are too small.

With respect to compression with financial entities, the FHLBs commented that financial entities should not be subject to the same compression requirements as SDs and MSPs as the swap portfolios of such entities do not, by definition, pose a significant risk to the overall financial system, such requirements could have adverse effects for such entities because their tax and accounting treatment may differ significantly from those of SDs, and such requirements may discourage financial entities from using swaps for hedging or risk mitigation.

Freddie Mac believes that mandatory portfolio compression should be limited to swaps that match and offset cash flows exactly, and that any compression requirement allow for exceptions for end users relying on swaps for hedging purposes or that otherwise believe the termination of an existing swap would have an adverse effect on remaining trades.

With respect to insurers, NAIC stated that state insurance laws require insurers to "tag" each swap position to specific hedging, replication, or income generation transactions, giving insurance regulators complete transparency into the swap position carried by insurers. NAIC is concerned that the proposed compression requirements, despite the exception in § 23.503(c)(3)(i), may require SDs and MSPs to terminate fully offsetting swaps that include swaps held by insurers for hedging of specific assets and liabilities, hindering state regulators' ability to regulate insurers. NAIC requested that the Commission modify the rule so that any swap position of an insurer that is specifically designated as a hedge as required by state insurance statutory accounting rules be allowed to remain outstanding and not be subject to portfolio compression rules.

MetLife also strongly opposed any mandated compression of offsetting swap positions. MetLife believes that the safe harbor in the proposed rules for exclusion of swaps "likely to increase significantly the risk exposure" of a party is not sufficiently broad to protect a party's essential hedging transactions. MetLife recommended that MSPs and other end users be permitted to opt out of compression for transactions that are bona fide hedges. Specifically, MetLife stated that the compression requirements may conflict with state insurance laws governing allocation of hedging transactions to specific assets and liabilities. MetLife concurred with other commenters in urging the Commission to exclude insurance companies from any mandatory portfolio compression requirement.

On the other hand, Eris Exchange stated that it has clearly heard that the swap trading community welcomes the Commission's proposed compression rule. Eris Exchange believes the end user community is optimistic that financial reform will lead to greater position netting and the ability to more freely unwind aged swap trades without having to go through a cumbersome novation process involving substantial operational burden and negotiated up-front payments.

Having considered these comments, the Commission notes that, as discussed above, the rule has been modified to require SDs and MSPs to establish policies and procedures for engaging in portfolio compression with non-SDs and non-MSPs when requested by such counterparties. The Commission believes this change addresses the comments of non-SDs and non-MSPs discussed above.

6. Application of Portfolio Compression by Asset Class

Proposed § 23.503 applied uniformly to all swaps, regardless of asset class. The Commission requested comment regarding whether the compression requirement should be restricted to particular asset classes.

ISDA commented that compression in asset classes other than credit and interest rates would be extremely costly and the benefits would be limited. ISDA stated that the industry will need to develop practices for each additional asset class because methods used in one asset class are not portable to other asset classes with distinct characteristics. ISDA specifically recommended that the following asset classes be excluded from any compression requirements:

- Foreign exchange swaps, which achieve compression through daily trade aggregation in CLS and have short tenors;
- Equity derivatives, because they are broadly positional in nature, there is a lack of standardization, and they are broadly hedged; and
- Commodity derivatives, because notional amounts are low and compression may only be worthwhile for oil and precious metals.

GFED also recommended that the Commission exclude foreign exchange swaps from the portfolio compression requirements as most foreign exchange swaps are short dated (i.e., three to six months average, one month for options) and the costs of implementation likely outweigh the limited benefits.

As noted above, Markit stated that portfolio compression was recently attempted in the commodities and foreign exchange asset classes, but was not pursued further because the trial cycles had limited success.

As discussed above, the Commission has modified the rule to remove the mandatory compression requirement and replace it with a requirement that SDs and MSPs establish policies and procedures for the regular evaluation of compression opportunities with other SDs and MSPs, when appropriate, and for engaging in compression with non-SDs and non-MSPs upon request. The Commission believes this change addresses commenters' concerns regarding the inappropriate or inefficient application of portfolio compression to certain asset classes.

7. Bilateral Uncleared Swap Portfolio Compression—§ 23.503(b)

Proposed § 23.503(b) required SDs and MSPs to engage in bilateral portfolio compression exercises at least once every calendar year with their swap counterparties that were also SDs or MSPs, unless the SD or MSP participated in a multilateral compression exercise in which such counterparties also participated.

With respect to this proposal, ISDA commented that the move to clearing will reduce the need for bilateral/uncleared trade compression because most fungible, liquid products in the credit and rates markets will be in DCOs.

The Commission believes that the changes to the proposed rule discussed above will address commenters' concerns regarding the inefficient application of portfolio compression to uncleared swaps. Specifically, the rule as adopted will not require SDs and MSPs to engage in bilateral compression, but only require that registrants establish policies and procedures for periodically engaging in such compression where appropriate.

8. Termination of Fully-Offsetting Bilateral Swaps—§ 23.503(a)

Proposed § 23.503(a) required SDs and MSPs to terminate fully offsetting swaps with other SDs or MSPs no later than the close of business on the business day following the day the fully offsetting swap was executed.

Commenting on this proposal, The Working Group stated that an SD or MSP with a regulatory requirement for functional separation may have legitimate reasons for maintaining offsetting long and short positions, thus the Commission should not mandate termination of fully-offsetting swaps, but only require that registrants have policies and procedures for termination of such swaps in appropriate circumstances. The Working Group also argued that requiring registrants to run and monitor daily systems for the detection of completely offsetting swaps where there are likely to be none is unnecessarily burdensome. Finally, The Working Group believes that the one business day time period for terminating fully-offsetting swaps is unnecessarily burdensome and should be revised to allow for one week.

ISDA believes the requirement for registrants to terminate fully-offsetting swaps between registrants to be unnecessary because such swaps are not sources of material risk. ISDA believes compliance with the rule would be extremely difficult and expensive to implement as compliance will require new processes to identify single offsetting trades. In addition, ISDA stated that perfectly offsetting swaps are not common and recommends the Commission clarify whether only perfect offsets are required to be terminated.

The Commission finds these comments persuasive and is modifying the rule to require only that SDs and MSPs establish policies and procedures to terminate fully offsetting swaps with other SDs and MSPs in a timely fashion, where appropriate. The Commission believes this modification allows SDs and MSPs to design policies and procedures that permit the maintenance of offsetting long and short positions for legitimate business reasons.[45] The Commission has also determined to remove the one-day termination requirement as a cost-saving measure and to replace it with the phrase ''in a timely fashion.''

9. Compression of Cleared Swaps

The proposed regulation did not differentiate between cleared swaps and uncleared swaps.

In this respect, ISDA believes that no compression requirement should attach to cleared trades, but, in the alternative, ISDA recommended the Commission clarify that complying with a DCOs compression requirements will satisfy the compression requirements of the proposed rule. Likewise, MFA stated that end users should not be required to engage in multilateral portfolio compression for cleared swaps.

Having considered these comments, and in light of the portfolio compression requirements under the Commission's regulations for DCOs,[46] the Commission has concluded that it is unnecessary to apply the requirements of this rule to swaps that are cleared by a DCO and has modified the rule accordingly. The Commission notes that this change is parallel to the portfolio reconciliation

[45] Compare with ESMA Draft Technical Standards, Article 3 RM, subsection 3, (stating that ''counterparties shall terminate each of the fully offset OTC derivative contracts not later than when the compression exercise is finalized.'')

[46] *See* 17 CFR 39.13(h)(4), Derivatives Clearing Organization General Provisions and Core Principles, 76 FR 69334, 69383 (Nov. 8, 2011).

rule, which also does not apply to swaps cleared by a DCO.

10. Mandatory Multilateral Compression Offered by a DCO or SRO—§ 23.503(c)(2)

Proposed § 23.503(c)(2) required SDs and MSPs to participate in all multilateral portfolio compression exercises offered by a DCO of which the SD or MSP is a member or an SRO of which the SD or MSP is a member.

Commenting on this aspect of the proposal, both ISDA and TriOptima stated that mandating compression offered by a DCO or SRO will inhibit competition among providers of compression services. ISDA is concerned that members of DCOs and SROs may become bound to compression services with inadequate transparency, insufficient testing and lack of price competition. ISDA recommends that the Commission permit registrants to select the compression service provider, including for DCO or SRO-mandated compression exercises.

As discussed above, the Commission has removed the mandatory compression requirements from the rule as adopted. Nonetheless, in response to these comments, the Commission agrees that the rule should not demonstrate a preference for any type of compression services provider and has accordingly modified the rule to require SDs and MSPs to evaluate multilateral compression exercises initiated, offered, or sponsored by any third party. This change also comports with the decision to change the final DCO rules to provide for voluntary participation in compression exercises.

11. Risk Tolerances in Multilateral Portfolio Compression—§ 23.503(c)(3)(ii)

Proposed § 23.503(c)(3)(ii) permitted SDs and MSPs to establish counterparty, market, cash payment, and other risk tolerances, and to exclude specific potential counterparties for the purposes of multilateral compression exercises.

Commenting on this aspect of the proposal, The Working Group recommended that the Commission grant market participants broad discretion when setting ''risk tolerances'' for multilateral compression exercises, including:

- A broad array of risks for which swaps may be excluded from the exercise (e.g., regulatory risk, financial statement risk);
- The ability to express preference for preserving swaps with one counterparty over another for credit risk management purposes; and
- The ability to require that only identical swaps and not substantially similar swaps can be compressed.

Having removed the mandatory multilateral compression requirement from the rule, the Commission has also removed the portions of the rule related to setting risk tolerances. However, under the revised rule, SDs and MSPs must establish policies and procedures for engaging in multilateral compression exercises, and the Commission expects that these policies and procedures will address how the SD and MSP would determine which swaps to include and exclude from compression exercises and what risk tolerances it would accept. The Commission believes that this change addresses commenters' concerns regarding the discretion to determine risk tolerances in multilateral compression exercises.

12. Portfolio Compression Service Provider Standards

The proposed regulations did not prescribe standards for portfolio compression service providers, and Markit recommended that, due to the complexity of multilateral compression exercises, the Commission establish standards for compression service providers to ensure competency, timely service, and sufficient resources. The process for choosing compression service providers should be fair and open. Freddie Mac urged the Commission to closely scrutinize the necessity and propriety of the terms of business demanded by prospective service providers (including SDRs, SEFs and DCOs) and disapprove overreaching terms such as open-ended indemnification, disclaimer of liability, assertions of ownership over transactional data, and other intellectual property of service users.

Given that the rule as adopted no longer contains a mandatory compression requirement, the Commission believes that these comments regarding standards for service providers and overreaching terms are best addressed by competition in the market for providers of compression services.

13. Recordkeeping Requirement for Portfolio Compression—§ 23.503(e)

Propose § 23.503(e) required SDs and MSPs to maintain records of each bilateral and multilateral compression exercise, including dates, the swaps included in the exercise, the eligible swaps excluded from the exercise and the reason for such exclusion, the counterparty and risk tolerances specified for the exercise, and the results of the exercise. ISDA commented that the recordkeeping requirement for portfolio compression is too prescriptive in its detail. The Commission is modifying the rule to require simply that SDs and MSPs maintain complete and accurate records of all compression exercises. As a matter of good practice, the Commission anticipates that market participants will make and maintain all necessary records of any swaps that are netted down, new swaps entered into, and any swaps that are submitted for compression but not compressed. In addition, the Commission observes that the rule does not prohibit SDs and MSPs from relying on third-party service providers to achieve compliance with the rule, although the responsibility for compliance cannot be delegated.

III. Effective Dates and Compliance Dates

In the Documentation NPRM and Confirmation NPRM, the Commission requested comment on the length of time necessary for registrants to come into compliance with the proposed rules. As discussed further below, the Commission also proposed a compliance schedule, § 23.575, for swap trading relationship documentation, § 23.504, in a separate release in September 2011.

A. Comments Regarding Compliance Dates

1. Documentation NPRM

With respect to § 23.504, The Working Group recommended that the Commission delay promulgating rules on swap documentation until it has finalized all required rules to be issued under the Dodd-Frank Act and can fully analyze the potential effect of documentation rules on the swap markets, or, in the alternative, adopt a general framework with an extended period of time for implementation to allow market participants to design appropriate documentation standards. Further, if the Commission should decide to make the proposed rules applicable to existing transactions, then The Working Group recommended that the Commission provide a short term safe-harbor for existing transactions and give the market 36 months to come into compliance. If the Commission should decide not to make the proposed rules applicable to existing transactions, then The Working Group recommended that the Commission give the market 12 months to come into compliance.

ISDA & SIFMA requested that the Commission defer proposing an implementation timeline until the

Commission's rules and the SEC's rules relating to trading documentation are fully developed and the industry has been given the opportunity to address implementation issues with the Commission at that time.

FSR believes that the renegotiation of existing documentation would take significantly longer than six months and urged the Commission to recognize that negotiation of new credit support arrangements, including third-party custody arrangements, will be particularly time-consuming and thus requested that the Commission provide an appropriately long implementation timeframe. The Coalition of Derivatives End-Users proposed a period of not less than two years for implementation for end users because it is unclear how each SD and MSP would seek to implement changes to comply with swap documentation rules for both existing and new swaps. The Coalition believes this period of time will allow for discussions and negotiations across all swap counterparty relationships.

IECA recommended that a long implementation period be provided. Otherwise, SDs will have an advantage because they have more resources to apply than end users and it is likely that any standard amendment would come from industry groups such as ISDA, which primarily represents the interests of SDs. CIEBA is also concerned that a deadline for SDs and MSPs to bring their documentation into compliance would allow SDs and MSPs to present buy-side participants with a newly standardized set of documentation, and would result in buy-side participants having insufficient input into the substance of the documentation. CIEBA also noted that a number of its members reported that it is not uncommon for SDs to take up to a year to finalize an ISDA agreement with a pension plan fiduciary. If SDs were required to revise all their swap agreements, CIEBA believes that it could take years.

In contrast to the foregoing comments, Michael Greenberger commented that since many dealers already use documentation that will comply with the regulations, allowing a maximum of thirty days to comply with the rules following adoption should suffice.

In addition to the foregoing comments, the Commission received comments with respect to proposed compliance schedules for a number of proposed rules, including § 23.504.[47] In September 2011, the Commission proposed four compliance schedules for four separate provisions of the Dodd-Frank Act, including: (i) The clearing requirement; (ii) the trade execution requirement; (iii) trading documentation under section 4s; and (iv) margining requirements for uncleared swaps.[48] In its proposal, Swap Transaction Compliance and Implementation Schedule: Trading Documentation and Margining Requirements under Section 4s of the CEA, (Implementation Schedule NPRM), the Commission stated that the proposed compliance schedule for § 23.504 was designed to afford affected market participants a reasonable amount of time to bring their transactions into compliance with the requirements of the rule and to provide relief in the form of additional time for compliance. The schedule was intended to facilitate the transition to the new regulatory regime established by the Dodd-Frank Act in an orderly manner that does not unduly disrupt markets and transactions. To this end, the Commission proposed § 23.575, under which an SD or MSP would be afforded ninety (90), one hundred eighty (180), or two hundred and seventy (270) days to bring its swap trading relationship documentation with its various counterparties into compliance with the requirements of § 23.504, depending on the identity of each such counterparty. In the proposal, market participants that are financial entities, as defined in section 2(h)(7)(C) of the CEA, were grouped into the following four categories:

- Category 1 Entities included SDs, security-based swap dealers, MSPs, major security-based swap participants, and active funds (defined as any private fund as defined in section 202(a) of the Investment Advisers Act of 1940), that is not a third-party subaccount and that executes 20 or more swaps per month based on a monthly average over the 12 months preceding this adopting release.
- Category 2 Entities included commodity pools; private funds as defined in section 202(a) of the Investment Advisers Act of 1940 other than active funds; employee benefit plans identified in paragraphs (3) and (32) of section 3 of the Employee Retirement Income and Security Act of 1974; or persons predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature as defined in section 4(k) of the Bank Holding Company Act of 1956, provided that the entity is not a third-party subaccount.
- Category 3 Entities include Category 2 Entities whose positions are held as third-party subaccounts.
- Category 4 Entities includes any person not included in Categories 1, 2, or 3.

Proposed § 23.575 required SDs and MSPs to be in compliance with § 23.504 no later than 90 days after publication of the final rule in the **Federal Register** for swap transactions with a Category 1 Entity, no later than 180 days after publication for swap transactions with a Category 2 Entity, and no later than 270 days after publication for swap transactions with a Category 3 Entity or Category 4 Entity.

The Commission received approximately 19 comments with respect to the compliance phasing proposal, each of which it considered in finalizing the compliance dates for the rule, as discussed below.

a. Definition of ''Active Fund''

The proposal defined ''active fund'' as ''any private fund as defined in section 202(a) of the Investment Advisers Act of 1940, that is a not a third party subaccount and that executes 20 or more swaps per month based on a monthly average over the 12 months preceding * * *.''

Commenting on this definition, the Association of Institutional Investors (AII) stated that basing the definition on an average of 20 swap transactions per month is arbitrary. AII believes that the Commission should collect data under swap transaction reporting rules and then make a determination, but, in the alternative, AII recommended that the threshold be higher and that the definition specify the type of swaps that count towards the threshold. FIA/ISDA/SIFMA and Vanguard also commented that the average monthly threshold should be raised, and recommended that the threshold be raised to include only those funds averaging more than 200 transactions per month.

MFA recommended that the definition be eliminated because it is over-inclusive, difficult to administer, and unnecessarily divides the class of buy-side market participants. Under MFA's view, all private funds should be Category 2 Entities. If the Commission does not delete the definition, MFA

[47] *See* Swap Transaction Compliance and Implementation Schedule: Trading Documentation and Margining Requirements under Section 4s of the CEA, 76 FR 58176 (Sept. 20, 2011) (Implementation Schedule NPRM).

[48] The trading documentation and margining requirements compliance schedules were proposed in one release. *See id.* The clearing requirement and trade execution requirement were proposed in another release, Swap Transaction Compliance and Implementation Schedule: Clearing and Trade Execution Requirements under Section 2(h) of the CEA, 76 FR 58186 (Sept. 20, 2011). The Commission finalized the compliance schedule for the clearing requirement on July 24, 2012. *See* Swap Transaction Compliance and Implementation Schedule: Clearing Requirement Under Section 2(h) of the CEA, 77 FR 44441 (July 30, 2012). The compliance schedules for margin for uncleared swaps and the trade execution requirement will be finalized separately.

requested clarification regarding those swaps that are to be included in the calculation, e.g., novations, amendments, partial tear-ups, etc.

On a different tack, FSR stated that the definition of ''active fund'' is unclear and needs further clarification to distinguish between active fund and ''third-party subaccount.'' FSR represented that its fund manager members believe that most (if not all) entities that would fall into the term ''active fund'' would also constitute ''third-party subaccounts.''

The American Council of Life Insurers (ACLI) commented that the frequency of trading is not an appropriate indicator of experience or available resources for determining which entities can comply most quickly. Similarly CDE recommended a minimum notional amount monthly average threshold to avoid capturing smaller end-users and excluding hedges and inter-affiliate swaps from the monthly average threshold.

On the other hand, Better Markets and Chris Barnard supported the proposal, stating that average monthly trading volume is the appropriate proxy for determining an entity's ability to comply with the proposed implementation schedule and is better than notional volume.

The Alternative Investment Management Association (AIMA) also believes that the average number of swaps executed during the previous 12 months is a good proxy for determining what is an active fund, but recommended that the definition should include private funds regardless of whether they are a third party subaccount or not. Otherwise, private funds that are not subaccounts will be disadvantaged relative to those that are, in terms of the cost of entering into swaps during the course of the implementation schedule. AIMA considered alternatives to the definition but believes that instituting an ''assets under management'' threshold for the definition of active fund may be problematic, as notwithstanding such a threshold, a manager may invest in other types of financial instruments such that they do not in fact have the experience or resources to more quickly comply with the regulations. AIMA also believes that commodity pools that are not private funds, but that execute 20 or more swaps on average per month, should be included in the definition.

Having considered the comments received, the Commission believes that the definition of ''active fund'' appropriately uses a transaction-based trigger to distinguish between funds more active in the swaps market and those that are less so. However, in response to comments that an average of 20 transactions per month may be overly inclusive and may cause some smaller entities, less well-positioned for compliance with shorter implementation timeframes, to fall within the definition. Accordingly, the Commission has determined to raise the threshold to 200 swap transactions on average per month so as to ensure only more active participants in the market are included within the definition. The Commission also agrees with commenters that establishing an appropriate minimum notional amount applicable to all participants in the swap market, or assets under management standard, to be impracticable.

However, the Commission does not believe it is appropriate to create exclusions for the types of swap transactions within the definition given the administrative burdens of monitoring such distinctions for purposes of the proposed implementation schedule. In response to commenters seeking clarification of what types of swap transactions are to be included in the monthly calculation, the Commission notes that the proposed implementation schedule, and the compliance dates adopted in this release, both refer to ''swaps'' and not ''swap transactions.'' ''Swap transaction'' is defined in § 23.500 to include assignments, novations, amendments, and other events that § 23.501 requires to be documented by confirmation. Therefore, in response to commenter's concerns, the Commission confirms that the active fund threshold of 200 swaps per month refers to ''swaps'' as defined in section 1a(47) of the CEA and Commission regulations, but would not include assignments, novations, amendments, or like events that occur with respect to existing swaps.

b. Definition of ''Third-party Subaccount''

The Implementation Schedule NPRM defined ''third-party subaccount'' to mean ''a managed account that requires the specific approval by the beneficial owner of the account to execute documentation necessary for executing, confirming, margining or clearing swaps.'' Third-party subaccounts were designated as Category 3 Entities, whereas other funds were designated Category 1 or Category 2 Entities.

With respect to this definition, AII commented that the definition is too narrow given the administrative work required in managing an account, regardless of the execution authority. Further, AII stated that execution authority is not an industry standard, and thus divides the universe of separate accounts inappropriately. Similarly, the Investment Company Institute (ICI) stated that third party subaccounts, whether subject to the specific execution authority of the beneficiary or not, require managers to work closely with clients when entering into trading agreements on the customer's behalf. As such, no distinction should be made based on specific execution authority or lack thereof, and that all third party accounts should be uniformly classified as Category 3 Entities, allowing for a 270 day compliance period.

FIA/ISDA/SIFMA also recommended that all accounts managed for third parties, regardless of the execution authority, should be in the Category 3 Entity implementation phase. FIA/ISDA/SIFMA recommended that the Commission adopt a definition of ''third-party fund'' that is any fund that is not a private fund and is sub-advised by a subadvisor that is independent of and unaffiliated with the fund sponsor. A ''third-party subaccount'' would be defined as any account that is not a fund and is managed by an asset manager, irrespective of the level of delegation granted by the account owner by the account owner to the asset manager.

Based on the comments received, the Commission is revising the definition of Third-Party Subaccount to mean an account that is managed by an investment manager that (1) is independent of and unaffiliated with the account's beneficial owner or sponsor, and (2) is responsible for the documentation necessary for the account's beneficial owner to document swaps as required under section 4s(i) of the CEA. In modifying this definition, the Commission is taking into account the point made by AII, FIA/ISDA/SIFMA, and ICI that all investment managers will need additional time to comply with the trading documentation requirements regardless of whether they have explicit execution authority. However, the definition retains the nexus between the investment manager and the documentation needed for swaps under section 4s(i) of the CEA. In other words, if the investment manager has no responsibility for documenting the swap trading relationships, then that account would be required to come into compliance with the documentation requirements within 180 days. For those accounts under the revised definition, however, the Commission believes that the 270-day deadline is more appropriate. Given the general notice that investment managers have had about the Dodd-Frank Act's documentation requirements for SDs and MSPs since the enactment of the statute in July, 2010, managers should have been able to consider and plan the infrastructure and resources that are necessary for all of their accounts, including Third-Party Subaccounts, to comply with the documentation requirements. Thus, the 180- and 270-day deadlines should provide adequate time to accommodate all managed accounts.

c. Definitions of Categories of Entities

The Commission received several comments with respect to the definitions of the categories of entities to which the proposed implementation schedules applied.

Encana and EEI, National Rural Electric Cooperative Association, and Electric Power Supply Association (Joint Associations) believe that the definition of Category 4 Entity under the proposed implementation schedules should expressly include non-financial end users.

The Coalition for Derivatives End-Users argued that financial end-users should be treated identically to non-financial end-users because they do not pose systemic risk, and therefore, should be given the most time to comply with the requirements.

ICI requested clarification that a market participant can determine whether it is an MSP for purposes of the proposed implementation schedules at the same time that it is required to review its status as an MSP under other Commission and SEC rules.

CIEBA requested that in-house ERISA funds should be in the group with the longest compliance time, and not Category 2 Entities, arguing that these funds are not systemically risky, and they typically rely upon third-party managers for some portion of their fund management. Splitting in-house and external accounts (i.e., those accounts meeting the Implementation Schedule NPRM's definition of third-party subaccount and which are therefore Category 3 Entities) of the same ERISA plan will impact risk management given different implementation schedules. The distinction will also cause pension funds to bear the costs of compliance because they will need to comply prior to their third party managers who would be better positioned to provide insight and services in this regard.

The Commission considered the foregoing comments, and has determined to modify the category definitions in certain respects. In response to Encana and the Joint Associations, non-financial entities are clearly included amongst Category 4 Entities and SDs and MSPs are given 270 days to comply with the documentation requirement with respect to such entities.

With respect to issues raised by the Coalition for Derivatives End-Users regarding those financial entities included in Category 2, the Commission believes that those entities have been correctly categorized based upon the distinction between financial and non-financial entities under section 2(h)(7) of the CEA. The Commission believes that, just as Congress has required financial entities to be subject to required clearing due to their importance to the financial system, SDs and MSPs should be required to meet the documentation requirements of § 23.504 with such entities prior to being required to meet such documentation requirements with non-financial entities. However, the definition of Category 2 Entity is modified by removing the reference to ERISA plans. The Commission recognizes the concerns raised by CIEBA regarding splitting in-house and external accounts (i.e., those accounts meeting the definition of Third-Party Subaccount and permitted 270 days) of the same ERISA plan. In response to these concerns, the Commission is removing the reference to employee benefit plans as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income and Security Act of 1974. As a result, these ERISA plans will be afforded the longest compliance period (270 days).

In response to the comment from ICI, the Commission confirms that a potential MSP may be able to review its obligation to register as an MSP at the same time it is reviewing where it fits under the compliance dates adopted in this release depending on the nature and scope of an MSP's swaps activities. The Commission notes that its rule further defining MSP was published on May 23, 2012, and its rule further defining ''swap'' was published on August 13, 2012, so potential MSPs will necessarily have to review their registration obligations ahead of complying with the compliance dates adopted herein. However, if an entity discovers that it has crossed the threshold established under the MSP rules and is required to register during the 90-day period for Category 1 Entities, the Commission would permit that entity to petition for additional time to come into compliance with the § 23.504.[49]

d. Proposed Implementation Schedule

As outlined above, proposed § 23.575 required SDs and MSPs to be in compliance with § 23.504 no later than 90 days after publication of the final rule in the **Federal Register** for swap transactions with a Category 1 Entity, no later than 180 days after publication for swap transactions with a Category 2 Entity, and no later than 270 days after publication for swap transactions with a Category 3 Entity or Category 4 Entity.

With respect to the proposed schedule, FIA/ISDA/SIFMA believes that the proposed implementation schedule should be lengthened because of the significant burden associated with the documentation requirements. FIA/ISDA/SIFMA argued that it would be impossible to begin complying with all of the documentation requirements of § 23.504 at the same time.

AII stated that the proposed implementation schedule does not provide enough time for institutional investment advisors to comply given the volume of document negotiations that will need to occur concurrently, as well as operational changes required by the Commission and other regulators under the Dodd-Frank Act. AII argued that institutional investment advisers also will face special challenges trying to allocate block trades across multiple categories of counterparty, and managing multiple implementation schedules. AII believes that tight timeframes will create an imbalance in negotiations with smaller counterparties at risk of being ''shut out of the market'' if they do not accept terms of the dealer community. AII therefore recommended that all market participants should have 18 months to come into compliance after the rules have been finalized.

Encana believes non-financial end users should get more time to comply with the regulations given less familiarity with Commission regulations and the need to develop and implement policies and procedures.

CDE stated that it is unlikely that end-users and other entities relied on by end-users will be able to meet the requirements § 23.504 if the requirements are imposed on all swaps at the same time.

Chris Bernard generally agreed with the proposed implementation schedule, though he believes that documentation relating to the swap valuation provisions of § 23.504(b)(4) should be prioritized within the compliance schedule.

[49] Similarly, the Commission would consider allowing entities to petition for additional time to comply to the extent that they discover that they have exceeded the *de minimis* threshold under the swap dealer definition and are required to register during the 90-day period for Category 1.

The California Public Employees' Retirement System, the Colorado PERA, the Missouri State Employees' Retirement System, the Teacher Retirement System of Texas, and the State of Wisconsin Investment Board recommended a one year phase-in for pension funds because the strict procedures that exist to protect their participants may hamper their ability to more quickly make the required changes to documents and procedures.

FSR commented that compliance periods should be substantially longer, with Category 2 lasting at least a year, and not starting until a significantly longer Category 1 has completed. As smaller market participants face the risk of accepting unsuitable terms or being shut out of the market given the tight timeframes and lack of resources, additional time should be granted to entities hedging in the ordinary course of business.

ICI stated that implementation should be longer, such as 18–24 months to accommodate all of the changes that are necessary in the market, arguing that too short a deadline will disadvantage smaller market participants who may be shut out of the market. ICI also recommended that the proposed implementation schedules should only begin after all related rules are finalized.

ACLI stated that 180 days for Category 2 Entities is insufficient for insurance companies that will need to work with state regulators on changes to operations, to negotiate documents of first impression, especially given the scope of the documentation to be negotiated or changed.

The Commission acknowledges the concerns of commenters regarding negotiation imbalances if the scope of documentation to be changed is large, but believes that, with the modifications to the rules outlined above, most market participants will have documentation already in place that either meets the requirements of the rule or could meet such requirements with relatively modest amendments. Thus, the Commission believes that these changes plus the staggered timeframes of the compliance dates adopted in this release adequately address the concerns of commenters regarding the time and effort necessary to complete the necessary documentation.

2. Confirmation NPRM

With respect to §§ 23.501, 23.502, and 23.503 generally, GFED argued that the Commission should not implement the proposed rules prior to Treasury determining which foreign exchange products are subject to the proposed rules to avoid unnecessary costs and burdens, while MFA believes that the Commission should evaluate the notable differences in experience and resources of market participants related to post-trade processes prior to publishing final rules. MFA believes that the Commission's goals would be best served, and market disruption avoided, by providing market participants with additional time to design, test, and implement processes required to comply with the proposed rules.

Specifically with respect to § 23.501, MarkitSERV believes that the rules should be phased in based on a product-by-product analysis of complexity and average time to confirm similar transactions, while Chatham believes the confirmation requirements should be phased-in over 6 to 12 months and that non-SDs and non-MSPs should be the last participants required to comply with the rules. In addition, ISDA provided the Commission with details of the current percentage of transactions electronically traded and confirmed, voice traded and electronically confirmed, voice traded and manually confirmed, and electronically traded and manually confirmed by eight large dealers in the five major swap asset classes (credit, rates, commodities, foreign exchange, and equity derivatives). ISDA provided the Commission with a break-down of this data showing time to confirmation by asset class, and the differences between electronic confirmation in dealer-to-dealer transactions versus transactions with other counterparty types.

Specifically with respect to § 23.502, Chatham recommended that the Commission provide end-users with at least six months to one year to comply with the proposed reconciliation rules, while the OCC stated that many SDs will not be among the G–14 largest OTC derivatives dealers and, given the incremental progression that was necessary for the G–14 OTC derivatives dealers to develop the infrastructure necessary to increase reconciliation amongst themselves from weekly reconciliation for portfolios with 5,000 or more trades in 2008 to the current daily reconciliation for portfolios of 500 or more trades, the Commission must provide sufficient time for all registrants to develop the required infrastructure.

With respect to § 23.503, ISDA urged the Commission to consider a long phase-in period for any compression requirement due to significant administrative and logistical issues.

B. Compliance Dates

Having considered the comments received, the Commission is adopting the effective and compliance dates as set forth below.

1. Swap Trading Relationship Documentation—§ 23.504

The effective date of § 23.504 will be the date that is 60 days after publication of the final rules in the **Federal Register**.

The Commission proposed a compliance schedule, § 23.575, but has determined not to finalize its schedule in the form of a rule. Rather, compliance periods are outlined below. With respect to swap transactions with SDs, security-based swap dealers, MSPs, major security-based swap participants, or any private fund, as defined in section 202(a) of the Investment Advisers Act of 1940, that is not a third-party subaccount (defined below) and that executes 200 or more swaps per month based on a monthly average over the 12 months preceding this adopting release (active funds), SDs and MSPs must comply with § 23.504 by January 1, 2013.

With respect to swap transactions with commodity pools; private funds as defined in section 202(a) of the Investment Advisers Act of 1940 other than active funds; or persons predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature as defined in section 4(k) of the Bank Holding Company Act of 1956, provided that the entity is not an account that is managed by an investment manager that (1) is independent of and unaffiliated with the account's beneficial owner or sponsor, and (2) is responsible for the documentation necessary for the account's beneficial owner to document swaps as required under section 4s(i) of the CEA (third-party subaccounts), SDs and MSPs must comply with § 23.504 by April 1, 2013.

With respect to swap transactions with any other counterparty, SDs and MSPs must comply with § 23.504 by July 1, 2013.

2. Swap Confirmation—§ 23.501

The effective date of §§ 23.500 and 23.501 will be the date that is 60 days after publication of the final rules in the **Federal Register**.

With respect to confirmation, the Commission is establishing an implementation schedule in the rule, differentiated by swap asset class. For credit swaps and interest rate swaps (including cross-currency swaps), SDs and MSPs will be required to confirm swap transactions with other SDs and MSPs as soon as technologically practicable, but in any event by the end of the second day after the day of execution until February 28, 2014. After

February 28, 2014, SDs and MSPs must comply with the requirements of paragraph (a)(1).

For equity swaps, foreign exchange swaps, and other commodity swaps, SDs and MSPs will be required to confirm swap transactions with other SDs and MSPs as soon as technologically practicable, but in any event by the end of the third day after the day of execution until August 31, 2013. For the period between September 1, 2013 and August 31, 2014, SDs and MSPs will be required to confirm equity, foreign exchange, and other commodity swap transactions with other SDs and MSPs as soon as technologically practicable, but in any event by the end of the second day after the day of execution. After August 31, 2014, SDs and MSPs must comply with the requirements of paragraph (a)(1).

For credit and interest rate swap transactions (including cross-currency swaps) with counterparties that are not SDs or MSPs, SDs and MSPs will be required to send an acknowledgement of swap transactions as soon as technologically practicable, but in any event by the end of the first day after the day of execution until February 28, 2014. After February 28, 2014, SDs and MSPs must comply with the requirements of paragraph (a)(2).

For equity, foreign exchange, and other commodity swap transactions with counterparties that are not SDs or MSPs, SDs and MSPs will be required to send an acknowledgement of swap transactions as soon as technologically practicable, but in any event by the end of the second day after the day of execution until August 31, 2013. For the period between September 1, 2013 and August 31, 2014, SDs and MSPs will be required to send an acknowledgement of equity, foreign exchange, and other commodity swap transactions with counterparties that are not SDs or MSPs as soon as technologically practicable, but in any event by the end of the first day after the day of execution. After August 31, 2014, SDs and MSPs must comply with the requirements of paragraph (a)(2).

For credit and interest rate swap transactions (including cross-currency swaps) with financial entities, SDs and MSPs will be required to establish policies and procedures reasonably designed to ensure that they confirm swap transactions as soon as technologically practicable, but in any event by the end of the second day after the day of execution until February 28, 2014. After February 28, 2014, SDs and MSPs must comply with the requirements of paragraph (a)(3)(i).

For equity, foreign exchange, and other commodity swap transactions with financial entities, SDs and MSPs will be required to establish policies and procedures reasonably designed to ensure that they confirm swap transactions as soon as technologically practicable, but in any event by the end of the third day after the day of execution until August 31, 2013. For the period between September 1, 2013 and August 31, 2014, SDs and MSPs will be required to establish policies and procedures reasonably designed to ensure that they confirm equity, foreign exchange, and other commodity swap transactions with financial entities as soon as technologically practicable, but in any event by the end of the second day after the day of execution. After August 31, 2014, SDs and MSPs must comply with the requirements of paragraph (a)(3)(i).

For credit and interest rate swap transactions (including cross-currency swaps) with counterparties that are not SDs, MSPs, or financial entities, SDs and MSPs will be required to establish policies and procedures reasonably designed to ensure that they confirm swap transactions as soon as technologically practicable, but in any event by the end of the fifth day after the day of execution until August 31, 2013. For the period between September 1, 2013 and August 31, 2014, SDs and MSPs will be required to establish policies and procedures reasonably designed to ensure that they confirm credit and interest rate swap transactions with counterparties that are not SDs, MSPs, or financial entities as soon as technologically practicable, but in any event by the end of the third day after the day of execution. After August 31, 2014, SDs and MSPs must comply with the requirements of paragraph (a)(3)(ii).

For equity, foreign exchange, and other commodity swap transactions with counterparties that are not SDs, MSPs, or financial entities, SDs and MSPs will be required to establish policies and procedures reasonably designed to ensure that they confirm swap transactions as soon as technologically practicable, but in any event by the end of the seventh day after the day of execution until August 31, 2013. For the period between September 1, 2013 and August 31, 2014, SDs and MSPs will be required to establish policies and procedures reasonably designed to ensure that they confirm equity, foreign exchange, and other commodity swap transactions with counterparties that are not SDs, MSPs, or financial entities as soon as technologically practicable, but in any event by the end of the fourth day after the day of execution. After August 31, 2014, SDs and MSPs must comply with the requirements of paragraph (a)(3)(ii).

Solely for purposes of the implementation schedule applicable to § 23.501, swaps are divided into the following asset classes:

Credit swap means any swap that is primarily based on instruments of indebtedness, including, without limitation: Any swap primarily based on one or more broad-based indices related to instruments of indebtedness; and any swap that is an index credit swap or total return swap on one or more indices of debt instruments.

Equity swap means any swap that is primarily based on equity securities, including, without limitation: Any swap primarily based on one or more broad-based indices of equity securities; and any total return swap on one or more equity indices.

Foreign exchange swap has the meaning set forth in section 1a(25) of the CEA. It does not include swaps primarily based on rates of exchange between different currencies, changes in such rates, or other aspects of such rates (sometimes known as ''cross-currency swaps'').

Interest rate swap means any swap which is primarily based on one or more interest rates, such as swaps of payments determined by fixed and floating interest rates; or any swap which is primarily based on rates of exchange between different currencies, changes in such rates, or other aspects of such rates (sometimes known as ''cross-currency swaps'').

Other commodity swap means any swap not included in the credit, equity, foreign exchange, or interest rate asset classes, including, without limitation, any swap for which the primary underlying item is a physical commodity or the price or any other aspect of a physical commodity.

3. Portfolio Reconciliation & Portfolio Compression

The effective date of §§ 23.502 and 23.503 will be the date that is 60 days after publication of the final rules in the **Federal Register**.

With respect to § 23.502 (Portfolio Reconciliation) and § 23.503 (Portfolio Compression), SDs and MSPs that are currently regulated by a U.S. prudential regulator or are registrants of the SEC must comply with §§ 23.502 and 23.503 by the date that is 90 days after publication of this final rule in the **Federal Register**. SDs and MSPs that are not currently regulated by a U.S. prudential regulator and are not registrants of the SEC must comply with

§§ 23.502 and 23.503 by the date that is 180 days after publication of this final rule in the **Federal Register**.

C. Compliance Date Extension for Certain Business Conduct Standards With Counterparties

ISDA members have requested that the Commission align the compliance dates for the provisions of subpart H of part 23 that involve documentation [50] with the trading relationship documentation rules in this release. ISDA members have represented that industry-led efforts are underway to facilitate compliance with new Dodd-Frank Act documentation requirements and an alignment of compliance dates would allow the most efficient transition to compliance with part 23's documentation requirements.[51]

The Commission has decided to defer the compliance dates for certain provisions of subpart H until January 1, 2013. Compliance with the following provisions will be deferred until January 1, 2013: §§ 23.402; 23.410(c); 23.430; 23.431(a)–(c); 23.432; 23.434(a)(2), (b), and (c); 23.440; and 23.450.[52] Compliance with all other provisions will continue to be required by October 15, 2012.

IV. Cost Benefit Considerations

Section 15(a) of the CEA [53] requires the Commission to consider the costs and benefits of its actions before promulgating a regulation under the CEA or issuing certain orders. Section 15(a) further specifies that the costs and benefits shall be evaluated in light of five broad areas of market and public concern: (1) Protection of market participants and the public; (2) efficiency, competitiveness, and financial integrity of futures markets; [54] (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. The Commission considers the costs and benefits resulting from its discretionary determinations with respect to the Section 15(a) factors.

Under section 731 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Congress directed the Commission to ''adopt rules governing documentation standards for swap dealers and major swap participants.'' The statutory provision in question, section 4(s)(i)(1) of the CEA, laid out a broad and general directive relating to ''timely and accurate confirmation, processing, netting, documentation, and valuation of all swaps.'' In promulgating the final rules subject to this release, the Commission has taken its direction from the statutory text, but is exercising its discretion with regard to the specific requirements set forth in the rules—namely, to require SDs and MSPs to meet certain confirmation deadlines for their swap transactions with other SDs and MSPs, to have policies and procedures for confirming swap transactions with financial entities and non-financial entities within certain time periods, to engage in regular portfolio reconciliation and portfolio compression, and to ensure that their swaps are governed by appropriate trading relationship documentation.

In exercising its discretion, the Commission has taken into account a series of voluntary industry initiatives, including efforts to improve the confirmation, reconciliation, compression, documentation, and valuation of swaps, as well as the overarching goals of the Dodd-Frank Act: reducing systemic risk, increasing transparency, and promoting integrity within the financial system. As discussed below, these industry efforts provide a useful reference point for considering the Commission's action.

In the context of the relevant statutory provision and ongoing industry initiatives, in the sections that follow, the Commission discusses each requirement individually in light of cost-benefit issues raised by commenters and suggested alternatives. The Commission also summarizes and considers costs and benefits collectively for the set of confirmation, portfolio reconciliation, and portfolio compression rules, and separately for the swap trading relationship documentation rules.

A. Background

In the fall of 2008, an economic crisis threatened to freeze U.S. and global credit markets. The federal government intervened to buttress the stability of the U.S. financial system.[55] The crisis revealed the vulnerability of the U.S. financial system and economy to widespread systemic risk resulting from, among other things, poor risk management practices of financial firms and the lack of supervisory oversight for certain financial institutions as a whole.[56] More specifically, the crisis and the attendant failure of a series of large financial institutions demonstrated the need for direct regulation of the OTC derivatives markets.[57]

American International Group (AIG) is an example of how the stability of a large financial institution could be undermined by certain failures in risk management, internal controls with respect to trading positions, documentation, and valuation, AIG was a regulated U.S. insurance company nearly undone by its collateral posting obligations under swaps entered into by its subsidiary, AIG Financial Products (AIGFP). AIGFP suffered enormous losses from credit default swaps that it issued on certain underlying securities, which, because AIGFP's performance on such credit default swaps had been guaranteed by its parent, caused credit agencies to downgrade the credit rating of the entire AIG corporation. The downgrade triggered collateral calls and induced a liquidity crisis at AIG, which

[50] Subpart H of Part 23 of the Commission's Regulations, Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 FR 9734, 9824 (Feb. 17, 2012).

[51] ISDA is partnering with Markit to launch a technology-based solution enabling counterparties to amend their OTC derivatives documentation quickly and efficiently to comply with Dodd-Frank regulatory requirements. *See http://www2.isda.org/dodd-frank-documentation-initiative/.*

[52] The Commission's decision to defer compliance does not reflect an endorsement of the industry-led effort, nor does it imply that the Commission has reviewed the documentation protocol for compliance with Commission rules. All market participants are subject to the new compliance dates regardless of whether they participate in the protocol.

[53] 7 U.S.C. 19(a).

[54] Although by its terms section 15(a)(2)(B) of the CEA applies to futures markets only, the Commission finds this factor useful in analyzing regulations pertaining to swap markets as well.

[55] On October 3, 2008, President Bush signed the Emergency Economic Stabilization Act of 2008, which was principally designed to allow the U.S. Treasury and other government agencies to take action to restore liquidity and stability to the U.S. financial system (e.g., the Troubled Asset Relief Program—also known as TARP—under which the U.S. Treasury was authorized to purchase up to $700 billion of troubled assets that weighed down the balance sheets of U.S. financial institutions). *See* Pub. L. 110–343, 122 Stat. 3765 (2008).

[56] *See* Financial Crisis Inquiry Commission, ''The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States,'' Jan. 2011, at xxvii, available at *http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf* [hereinafter the FCIC Report].

[57] *See id.* at 25 (concluding that ''enactment of * * * [the Commodity Futures Modernization Act of 2000 (''CFMA'')] to ban the regulation by both the federal and state governments of over-the-counter (OTC) derivatives was a key turning point in the march toward the financial crisis.''). *See also id.* at 343 (''Lehman, like other large OTC derivatives dealers, experienced runs on its derivatives operations that played a role in its failure. Its massive derivatives positions greatly complicated its bankruptcy, and the impact of its bankruptcy through interconnections with derivatives counterparties and other financial institutions contributed significantly to the severity and depth of the financial crisis.'') and *id.* at 353 (''AIG's failure was possible because of the sweeping deregulation of [OTC] derivatives, [* * *] including capital and margin requirements that would have lessened the likelihood of AIG's failure. The OTC derivatives market's lack of transparency and of effective price discovery exacerbated the collateral disputes of AIG and Goldman Sachs and similar disputes between other derivatives counterparties.'').

resulted in over $85 billion of indirect assistance from the Federal Reserve Bank of New York to prevent AIG's default.[58]

The inability to value its portfolio accurately and agree on valuations with its counterparties posed a serious problem for AIG during the financial crisis.[59] Swap valuation disputes were common, because, among other things, there was widespread market opacity for many of the inputs needed to properly value many swaps.[60] As reported during the fall of 2008, ''the methods that A.I.G. used to value its derivatives portfolio began to come under fire from trading partners.'' [61] As explained by a Congressional panel, ''the threats within [AIG's] businesses emanated from outsized exposure to the deteriorating mortgage markets, *owing to grossly inadequate valuation and risk controls,* including insufficient capital buffers as losses and collateral calls mounted'' (emphasis added).[62]

The financial crisis also highlighted the significance of substandard or missing legal documentation. For example, the Lehman Brothers Holding Inc. (LBHI) bankruptcy offers another stark lesson on how failures in risk management, documentation, and valuation can contribute to the ultimate collapse of an entire financial institution. During the days leading up the LBHI's bankruptcy, potential buyers were stymied by the state of Lehman's books.[63] As recognized by PriceWaterhouseCoopers in a lessons learned document put together after the Lehman bankruptcy, effective risk management requires the existence of sound documentation, daily reconciliation of portfolios, rigorously tested valuation methodologies, and sound collateralization practices.[64]

More broadly, the President's Working Group (PWG) on Financial Policy noted shortcomings in the OTC derivative markets as a whole during the crisis. The PWG identified the need for an improved integrated operational structure supporting OTC derivatives, specifically highlighting the need for an enhanced ability to manage counterparty risk through ''netting and collateral agreements by promoting portfolio reconciliation and accurate valuation of trades.'' [65]

Congress sought to address the deficiencies in the regulatory system that contributed to the financial crisis through the enactment of the Dodd-Frank Act, which was signed by President Obama on July 21, 2010.[66] Title VII of the Dodd-Frank Act amended the CEA [67] to overhaul the structure and oversight of the OTC market that previously had been subject to little or no oversight.[68] One of the cornerstones of this legislation is the establishment of a new statutory framework for comprehensive regulation of financial institutions that participate in the swaps market as SDs or MSPs, which must register and are subject to greater oversight and regulation.[69] This new framework for SDs and MSPs seeks to reduce the potential for the recurrence of the type of financial and operational stresses that contributed to the 2008 crisis.

Efforts to regulate the swaps market are underway not only in the United States but also abroad in the wake of the 2008 financial crisis. In 2009, leaders of the Group of 20 (G–20)—whose membership includes the European Union (EU), the United States, and 18 other countries—agreed that: (i) OTC derivatives contracts should be reported to trade repositories; (ii) all standardized OTC derivatives contracts should be cleared through central counterparties and traded on exchanges or electronic trading platforms, where appropriate, by the end of 2012; and (iii) non-centrally cleared contracts should be subject to higher capital requirements. In line with the G–20 commitment, much progress has been made to coordinate and harmonize international reform efforts, but the pace of reform varies among jurisdictions and disparities in regulations remain due to differences in cultures, legal and political traditions, and financial systems.[70]

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[58] The Federal Reserve Bank of New York explained its intervention as a means of preventing contagion concerns resulting from an AIG default from spreading financial losses to other firms. The FCIC argued and Gretchen Morgenson reported that the entire U.S. financial system might have been threatened by such a large default. *See* FCIC Report at 200–02 and 344–52 and Gretchen Morgenson, ''Behind Insurer's Crisis, Blind Eye to a Web of Risk,'' N.Y. Times, Sept. 27, 2008 [hereinafter Morgenson Article]. Corrected version published Sept. 30, 2008, available at *http://www.nytimes.com/2008/09/28/business/28melt.html?pagewanted=all.*

[59] *See* Testimony Before the Financial Crisis Inquiry Commission, including AIG/Goldman Sachs Collateral Call Timeline, available at *http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0701-AIG-Goldman-supporting-docs.pdf* (timeline documenting valuation disputes and collateral calls); Testimony of Joseph Cassano, available at *http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0630-Cassano.pdf;* and AIG Statement Summary, available at *http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0630-AIG-Statement-Summary.pdf.*

[60] The failure of the market to set a price for mortgage-backed securities led to wide disparities in the valuation of CDS referencing mortgage-backed securities (especially collateralized debt obligations). ''The illiquid market for some structured credit products, auction rate securities, and other products backed by opaque portfolios led to major write-downs across the industry in 2008. The resulting depletion of capital led to credit downgrades, which in turn drove counterparty collateral calls and sales of illiquid assets. This further depleted capital balances. Widening CDS spreads have become widely viewed as a leading indicator of a bank's financial health and viability.'' PriceWaterhouseCoopers, ''Lehman Brothers' Bankruptcy: Lessons learned for the survivors,'' Informational presentation for clients, August 2009, at 12, available at *http://www.pwc.com/en_JG/jg/events/Lessons-learned-for-the-survivors.pdf.* In addition, such wide disparities led to large collateral calls from dealers on AIG, hastening its downfall. *See* CBS News, ''Calling AIG? Internal Docs Reveal Company Silent About Dozens Of Collateral Calls,'' Jun. 23, 2009, available at: *http://www.cbsnews.com/stories/2009/06/23/cbsnews_investigates/main5106672.shtml.*

[61] *See* Morgenson Article.

[62] Congressional Oversight Panel, June Oversight Report: The AIG Rescue, Its Impact on Markets, and the Government's Exit Strategy, June 10, 2010, at 24, available at *http://cybercemetery.unt.edu/archive/cop/20110402010341/cop.senate.gov/documents/cop-061010-report.pdf.*

[63] *See* In re Lehman Brothers Holdings Inc., 08–13555, and *Giddens* v. *Barclays Capital Inc.,* 09–01732, U.S. Bankruptcy Court, Southern District of New York; *see also* Linda Sandler, ''Lehman Derivatives Records a 'Mess,' Barclays Executive Says,'' Bloomberg, Aug. 30, 2010, available at *http://www.bloomberg.com/news/2010-08-30/lehman-derivatives-records-a-mess-barclays-executive-says.html* (reporting on testimony provided in previously cited Lehman bankruptcy proceeding).

[64] *See* PriceWaterhouseCoopers, ''Lehman Brothers' Bankruptcy: Lessons learned for the survivors,'' Informational presentation for clients, August 2009, at 12–24, available at *http://www.pwc.com/en_JG/jg/events/Lessons-learned-for-the-survivors.pdf.*

[65] The President's Working Group on Financial Markets, ''Policy Statements on Financial Market Developments,'' Mar. 2008, available at *http://www.treasury.gov/resource-center/fin-mkts/Documents/pwgpolicystatemktturmoil_03122008.pdf.*

[66] Pub. L. 111–203, 124 Stat. 1376 (2010). The text of the Dodd-Frank Act is available at *http://www.cftc.gov/ucm/groups/public/@swaps/documents/file/hr4173_enrolledbill.pdf.*

[67] 7 U.S.C. 1, *et seq.*

[68] Prior to the adoption of Title VII, swaps and security-based swaps were by and large unregulated. The CFMA excluded financial OTC swaps from regulation under the CEA, provided that trading occurred only among ''eligible contract participants.'' Swaps based on exempt commodities—including energy and metals—could be traded among eligible contract participants without CFTC regulation, but certain CEA provisions against fraud and manipulation continued to apply to these markets. No statutory exclusions were provided for swaps on agricultural commodities by the CFMA, although they could be traded under certain regulatory exemptions provided by the CFTC prior to its enactment. Swaps based on securities were subject to certain SEC enforcement authorities, but the SEC was prohibited from prophylactic regulation of such swaps.

[69] The provisions of the CEA relating to swaps that were enacted by Title VII of the Dodd-Frank Act are also referred to herein as ''the Dodd-Frank requirements.''

[70] Legislatures and regulators in a number of foreign jurisdictions are undertaking significant regulatory reforms over the swaps market and its participants. *See* CFTC and SEC, Joint Report on International Swap Regulation Required by Section

Continued

Even before the passage of the Dodd-Frank Act, market participants and regulators had been paying particular attention to the post-trade processing of swaps. For example, operational issues associated with the OTC derivatives market have been the focus of reports and recommendations by the PWG.[71] In response to the financial crisis in 2008, the PWG called on the industry to improve trade matching and confirmation and to promote portfolio reconciliation.

Significantly, beginning in 2005, the Federal Reserve Bank of New York (FRBNY) undertook a targeted, supervisory effort to enhance operational efficiency and performance in the OTC derivatives market, by increasing automation in processing and by promoting the timely confirmation of trades. Known as the OTC Derivatives Supervisors' Group (ODSG), the FRBNY led an effort with OTC derivatives dealers' primary supervisors, trade associations, industry utilities, and private vendors, through which market participants (including buy-side participants) regularly set goals and commitments to bring infrastructure, market design, and risk management improvements to all OTC derivatives asset classes. Over the years, the ODSG expanded its focus from credit derivatives to include interest rate derivatives, equity derivatives, foreign exchange derivatives, and commodity derivatives. Along with this expanded focus came increased engagement with market participants on cross-asset class issues. Specifically, the ODSG encouraged the industry to commit itself to a number of reforms, including improved operational performance with respect to the OTC derivatives confirmation process, portfolio reconciliation, and portfolio compression. The regulations being adopted by the Commission in this adopting release build upon the ODSG's work.[72] The specific operational performance enhancements upon which each of the Commission's rules included in this adopting release expressly build, the comments to the rule proposals related to the costs and benefits of such rules, and the Commission's consideration of the costs and benefits of such rules are discussed below.

This final rule implements Dodd-Frank Act section 731, which is an important component of the comprehensive set of reforms passed by Congress to protect the American public and ''promote the financial stability of the United States'' in the wake of a financial crisis and the resulting recession that was caused in part by the lack of adequate regulation of financial markets.[73] The damage to the American public has been tremendous. According to the U.S. Department of the Treasury, over $19 trillion in household wealth and over 8.8 million jobs were lost during the recession that began in late 2008.[74] Between September 2008 and May 2012 there have been approximately 3.6 million completed home foreclosures across the country.[75] The U.S. Census Bureau estimates that the number of households living below the poverty level rose 2.6 percent from 2007 to 2010.[76] The overarching purpose and benefit of this final rule, together with the other rules the Commission is implementing under Title VII of the Dodd-Frank Act is to identify and fix the structural weaknesses that contributed to the financial crisis in an effort to avoid a repeat of the same.

B. Swap Confirmation

The Government Accountability Office (GAO) found that the rapid expansion of the trading volume of swaps, such as credit derivatives, since 2002, caused stresses on the operational infrastructure of market participants. These stresses, in turn, caused the participants' back office systems to fail to confirm the increased volume of trades for a period of time.[77] The GAO found that the lack of automation in trade processing and the purported assignment of positions by transferring parties to third parties without notice to their counterparties were factors contributing to this backlog. If transactions, whether newly executed or recently transferred to another party, are left unconfirmed, there is no definitive written record of the contract terms. Thus, in the event of a dispute, the terms of the agreement must be reconstructed from other evidence, such as email trails or recorded trader conversations. This process is cumbersome and may not be wholly accurate. Moreover, if purported transfers of swaps, in whole or in part, are made without giving notice to the remaining parties and obtaining their consent, disputes may arise as to which parties are entitled to the benefits and subject to the burdens of the transaction.

As the work of the ODSG demonstrates, the industry is capable of swift movement to contemporaneous execution and confirmation. A large back-log of unexecuted confirmations in the CDS market created by prolonged negotiations and inadequate confirmation procedures were the subject of the first industry commitments made by participating dealers to ODSG.[78] In October 2005, the participating dealers committed to reduce by 30 percent the number of confirmations outstanding more than 30 days within four months. In March 2006, the dealers committed to reduce the number of outstanding confirmations by 70 percent by June 30, 2006. By September 2006, the industry had reduced the number of all outstanding CDS confirmations by 70 percent, and the number of CDS confirmations outstanding more than 30 days by 85 percent. The industry achieved these targets largely by moving 80 percent of total trade volume in CDS to confirmation on electronic platforms, eliminating backlogs in new trades.

By the end of 2011, the largest dealers were electronically confirming over 95

719(c) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Jan. 31, 2012, at 23, available at *http://www.cftc.gov/ucm/groups/public/@swaps/documents/file/dfstudy_isr_013112.pdf.* For example, the European Parliament adopted the substance of the European Market Infrastructure Regulation (''EMIR'') on March 29, 2012. As discussed below, ESMA has proposed regulations that are very similar to those being adopted by the Commission in this release.

[71] *See, e.g.,* Press Release, ''President's Working Group on Financial Markets, Progress Summary on OTC Derivatives Operational Improvements'' (Nov. 2008).

[72] ''No more Fed letter commitments expected, says Dudley,'' Risk Magazine, May 16, 2012, available at *http://www.risk.net/risk-magazine/news/2174981/fed-letter-commitments-expected-dudley* (William Dudley, president of the Federal Reserve Bank of New York, stated ''Now we're moving to a new regime, where the OTC derivatives market is being regulated for the first time. As we do that, and the SEC and CFTC stand up in terms of regulation, it's completely appropriate for us to stand down.'').

[73] Dodd-Frank Act, Preamble.

[74] *See* U.S. Department of the Treasury, ''The Financial Crisis Response—In Charts,'' April 2012, available at *http://www.treasury.gov/resource-center/data-chart-center/Documents/20120413_FinancialCrisisResponse.pdf. See also* Congressional Budget Office, The Budge and Economic Outlook: Fiscal Years 2012–2022, at 26 (Jan. 2012) (explaining gross domestic product (GDP) has fallen dramatically and it is not expected to return to normal levels until at least 2018. At that time, the cumulative shortfall in GDP relative to potential GDP is expected to reach $5.7 trillion).

[75] *See* CoreLogic, ''CoreLogic Reports 66,000 Completed Foreclosures Nationally,'' May 2012, available at *http://www.corelogic.com/about-us/news/corelogic-reports-66,000-completed-foreclosures-nationally-in-april.aspx.*

[76] *See* U.S. Census Bureau, ''Income, Poverty, and Health Insurance Coverage in the United States: 2010,'' at 14 (Sept. 2010), available at *http://www.census.gov/prod/2011pubs/p60-239.pdf.*

[77] U.S. Government Accountability Office, ''Credit Derivatives: Confirmation Backlogs Increased Dealers' Operational Risks, But Were Successfully Addressed After Joint Regulatory Action,'' GAO–07–716 (2007) at 3–4.

[78] *See* October 4, 2005 industry commitment letter to the Federal Reserve Bank of New York, available at *http://www.newyorkfed.org/newsevents/news_archive/markets/2005/an050915.html.*

percent of OTC credit derivative transactions, and 90 percent were confirmed on the same day as execution (T+0). For the same period, the largest dealers were electronically confirming over 70 percent of OTC interest rate derivatives (over 90 percent of trades with each other), and over 80 percent were confirmed T+0. The rate of electronic confirmation of OTC commodity derivatives was somewhat lower—just over 50 percent, but over 90 percent for transactions between the largest dealers.[79] These statistics provide some confidence that, over time, timely confirmation rates will continue to improve.

The primary benefit of timely and accurate confirmation is that the parties to a swap know what their deal is. In other words, a confirmation definitively memorializes all of the terms of the swap transaction, which is critical for all downstream operational and risk management processes. If transactions, whether newly executed or recently transferred to another party, are left unconfirmed, there is no definitive written record of the contract terms. Risk management processes dependent on the trade terms (such as collateral management, and payment and settlement systems) may be inaccurate, and, in the event of a dispute, the terms of the agreement must be reconstructed from other evidence, such as email trails or recorded trader conversations.

Recognizing the laudable gains in electronic confirmation processing by the industry and the risk reduction in the shortening of time periods between execution and confirmation, the Commission proposed a confirmation rule that would have required SDs and MSPs trading with each other to confirm their swap transactions within 15 minutes if the swap transaction was executed and processed electronically, within 30 minutes if the swap transaction was only processed electronically, and within the same calendar day if the swap transaction could not be processed electronically. Similarly, the Commission proposed that SDs and MSPs have policies and procedures for confirming swap transactions with financial entities within the same calendar day, and with counterparties that are not SDs, MSPs, or financial entities not later than the next business day.

Several commenters recognized the benefits of the Commission's confirmation proposal and wrote in support of the approach. Chris Barnard wrote that the proposal would increase transparency and promote legal certainty for swaps. CME stated that it supported the goals of improving the post-trade processing of swaps and ensuring timely and accurate confirmation of such data among counterparties. CME agreed with the overall approach taken by the Commission on this subject and with the goal of promulgating confirmation requirements that are effective, not duplicative and cost and time efficient to the industry. CME noted the cost-savings to market participants of confirming their swaps through DCOs, which is explicitly permitted under the swap confirmation rule.

On the other hand, multiple commenters objected to the Commission's proposal on cost grounds. Some read the proposal as detrimentally mandating electronic confirmation.[80] Other commenters argued that the short time periods permitted for confirmation would effectively require all terms of a swap to be negotiated prior to execution, increasing costs for the party that is most sensitive to timing of market conditions and increasing risk by leading to needless disputes and operational lapses.[81] Still others argued that financial entities should not be subject to shorter confirmation deadlines than non-financial entities.[82] Finally, some commenters stated that the rule would require changes in current market practice and it was unclear that the cost of additional resources to meet the requirements of the rule was outweighed by any enhanced transparency or reduction in systemic risk.[83] No commenter provided quantitative data on the comprehensive compliance costs of the rule as proposed, but ISDA and The Working Group enumerated costs related to adopting electronic confirmation procedures. ISDA stated that each asset class uses different electronic confirmation platforms, so a trader conducting trades in multiple asset classes would need to build the infrastructure necessary to integrate multiple platforms. Such expenditures are routine for dealers, says ISDA, but for smaller entities, the operational costs may impede their ability to hedge risk. The Working Group estimated that electronic confirmation could cost an SD or MSP in excess of $1,000,000 annually, citing that one third-party confirmation service charges $6.00 per trade. However, The Working Group cited no source for the proposition that potential SDs or MSPs currently execute the more than 166,000 trades annually that would be required to reach a $1,000,000 annual confirmation cost at $6.00 per trade.

The Commission carefully considered each of these comments in formulating the final rule and has responded to the cost concerns of commenters where doing so was in keeping with the benefit of timely and accurate memorialization of all the terms of a swap transaction between an SD or MSP and its counterparties. First, the final rule does not apply to swap transactions that are executed on a SEF or DCM or that are submitted for clearing to a DCO by the required confirmation deadline, so market participants that mostly transact in standardized swaps may not be affected by the rule, or will have their costs greatly reduced. This fact was highlighted by both CME and ICE in their comments to the proposed rule.

Second, the Commission notes that the final rule affirmatively does not mandate electronic confirmation. Instead, the final rule sets an ultimate deadline for confirmation of swap transactions among SDs and MSPs, while also requiring that if technologically practicable, such swap transactions be confirmed sooner. The deadline of ''the end of the first business day following the day of execution'' is modified to allow for more time if registrants are trading near the end of the trading day or if such registrants are in different time zones. With respect to swap transactions with non-SDs and non-MSPs, SDs and MSPs are only required to have policies and procedures in place that are reasonably designed to ensure confirmation by the end of the first business day following the day of execution (modified for end of day trading and time zone differences) for financial entities, or by

[79] *See* G15 Industry Confirmation Data dated April 4, 2012 provided by ISDA, available at *www.cftc.gov.*

[80] Chatham argued that the Commission should not mandate confirmation through an electronic matching platform, because such a mandate could preclude end-users from entering into swaps not yet available on matching platforms and could increase costs for end-users that do not engage in the volume of swaps necessary to justify the additional costs of connecting to electronic matching platforms. ABC & CIEBA also argued that the proposed rule could impose processes that require third-party service providers or new technology.

[81] The Working Group; ISDA; Chatham.

[82] CIEBA stated that the rule would impose costly increases in operational capacity for pension funds and recommended that the Commission provide for a ''close of next business day'' time limit for benefit plans, along with a requirement that SDs and MSPs provide an acknowledgement at the time of execution as well as a draft acknowledgement prior to execution. AMG argued that financial entities should not be subject to shorter time periods for confirmation because many may not have the operational resources to meet the deadlines. MFA stated that designation as a financial entity does not necessarily correlate with a large swap portfolio or being highly sophisticated, and thus the short time period for confirmation in the proposed rules may cause unwarranted economic disadvantages.

[83] BGA; MetLife; MFA; GFED; the FHLBs; AMG.

the end of the second business day following the day of execution for non-financial entities, rather than the next business day as proposed. The Commission would expect an SD's or MSP's policies and procedures to require sufficient pre-trade agreement on repetitive terms such that non-SD, non-MSP counterparties are able to execute in a timely manner without protracted pre-trade negotiations that may prove costly for market participants sensitive to execution timing. The requirement for policies and procedures (as opposed to hard deadlines) recognizes that SDs and MSPs cannot force their non-SD, non-MSP counterparties to adopt particular electronic confirmation processes, but must accommodate the needs of their counterparties while ensuring, to the extent possible, that confirmation is achieved within the rule's time periods.

In addition, to further reduce the burden of the rule on those market participants that are least able to quickly adapt to the rule's requirements, the Commission notes that compliance with the rule is implemented on a staggered basis. As discussed above under section III.B.2, compliance is required first for swaps in the credit and interest rate asset class, and, within that asset class, first for swaps among SDs, MSPs, and financial entities with a longer compliance period for swaps between SDs or MSPs and non-financial entities. Compliance is staggered similarly with respect to all other swaps, but with longer compliance periods.

The Commission understands that, for certain asset classes, the low number of transactions does not seem to justify increased expenditure on faster confirmations; however, the Commission is committed to decreasing the length of time between execution and confirmation in order to improve the efficiency of bilateral markets and decrease overall systemic risk resulting from outstanding unconfirmed trades among many participants. The Commission maintains that such benefits are significant and important regardless of asset class. Thus, the Commission has applied the same general timeframes to all asset classes, but has extended the compliance deadlines for commodity, equity, and foreign exchange asset classes in order to allow participants in those asset classes sufficient time to integrate faster confirmations without an immediate and potentially overwhelming burden.

Finally, the Commission notes that ESMA has proposed confirmation requirements that are substantially similar to those adopted by the Commission in this release.[84] By closely aligning confirmation requirements through consultation with ESMA, the Commission believes that SDs and MSPs will benefit from a largely unitary regulatory regime that does not require separate compliance and operational policies and procedures.

C. Portfolio Reconciliation

Disputes related to confirming the terms of a swap, as well as swap valuation disputes, have long been recognized as a significant problem in the OTC derivatives market.[85] Portfolio reconciliation is considered an effective means of identifying and resolving these disputes. The Commission recognizes that the industry has made significant progress in adopting the use of portfolio reconciliation to decrease the number of swap disputes.[86] In December 2008, the ODSG's group of 14 major dealers committed to execute daily portfolio reconciliations for collateralized portfolios in excess of 500 trades between participating dealers by June of 2009.[87] As of May 2009, all participating dealers were satisfying this commitment. In October 2009, the ODSG committed to publishing a feasibility study on market-wide portfolio reconciliation that would set forth how regular portfolio reconciliation could be extend beyond the ODSG dealers to include smaller banks, buy-side participants, and derivative end users. Consistent with this publication, the ODSG dealers expanded their portfolio reconciliation commitment in March 2010 to include monthly reconciliation of collateralized portfolios in excess of 1,000 trades with any counterparty. Most recently, the industry has been preparing a new ''Convention on the Investigation of Disputed Margin Calls'' and a new ''Formal Market Polling Procedure'' that are intended to ''create a consistent and predictable process * * * that eliminates present uncertainties and delays.''[88]

In light of these efforts the Commission proposed § 23.502, which required SDs and MSPs to reconcile their swap portfolios with one another and provide counterparties that are not registered as SDs or MSPs with regular opportunities for portfolio reconciliation. Specifically, proposed § 23.502 required SDs and MSPs to reconcile swap portfolios with other SDs or MSPs with the following frequency: daily for portfolios consisting of 300 or more swaps, at least weekly for portfolios consisting of 50 to 300 swaps, and at least quarterly for portfolios consisting of fewer than 50 swaps. For portfolios with counterparties other than SDs or MSPs, the proposed regulations required SDs and MSPs to establish policies and procedures for reconciling swap portfolios: daily for swap portfolios consisting of 500 or more swaps, weekly for portfolios consisting of more than 100 but fewer than 500 swaps, and at least quarterly for portfolios consisting of fewer than 100 swaps. In order for the marketplace to realize the full risk reduction benefits of portfolio reconciliation, the Commission also proposed to expand portfolio reconciliation to all transactions, whether collateralized or uncollateralized. For the swap market to operate efficiently and to reduce systemic risk, the Commission believes that portfolio reconciliation should be a proactive process that delivers a consolidated view of counterparty exposure down to the transaction level. By identifying and managing mismatches in key economic terms and valuation for individual transactions across an entire portfolio, the Commission proposal sought to require a process in which overall risk can be identified and reduced.

Agreement between SDs, MSPs, and their counterparties on the proper daily valuation of the swaps in their swap portfolio also is essential for the Commission's margin proposal. Under proposed rule § 23.151, non-bank SDs and MSPs must document the process by which they will arrive at a valuation for each swap for the purpose of collecting initial and variation margin.[89]

[84] *See* ESMA Draft Technical Standards, Article 1 RM, subsection 2 (stating that uncleared OTC derivatives ''shall be confirmed, where available via electronic means, as soon as possible and at the latest by the end of the same business day.''), and ESMA Draft Technical Standards, Article 1 RM, subsection 3 (stating that uncleared OTC derivatives ''shall be confirmed as soon as possible and at the latest by the end of the second business day following the date of execution'').

[85] *See* ISDA Collateral Committee, ''Commentary to the Outline of the 2009 ISDA Protocol for Resolution of Disputed Collateral Calls,'' June 2, 2009 (stating ''Disputed margin calls have increased significantly since late 2007, and especially during 2008 have been the driver of large (sometimes > $1 billion) un-collateralized exposures between professional firms.'').

[86] The Commission also recognizes and encourages the industry practice of immediately transferring undisputed collateral amounts.

[87] *See* June 2, 2009 summary of industry commitments, available at *http://www.isda.org/c_and_a/pdf/060209table.pdf.*

[88] *See* ''ISDA 2010 Convention on the Investigation of Disputed Margin Calls'' and ''ISDA 2010 Formal Market Polling Procedure.''

[89] *See* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 FR 23732, 23744 (April 28, 2011). Bank SDs and MSPs will also be required to document the process by which they will arrive at a valuation for each swap for the purpose of collecting margin under the

All non-bank SDs and MSPs must collect variation margin from their non-bank SD, MSP, and financial entity counterparties for uncleared swaps on a daily basis. Variation margin requires a daily valuation for each swap. For swaps between non-bank SDs and MSPs and non-financial entities, no margin is required to be exchanged under Commission regulation, but the non-bank SDs and MSPs must calculate a hypothetical variation margin requirement for each uncleared swap for risk management purposes under proposed § 23.154(b)(6).

Several commenters articulated the benefits of portfolio reconciliation and supported the Commission's proposal. TriOptima supported the regular reconciliation of all portfolios as a process that will identify issues that can minimize counterparty credit exposure and operational risk. Chris Barnard also supported the rule, stating that the rule should increase transparency, promote market integrity and reduce risk by establishing procedures that will promote legal certainty concerning swap transactions, assist with the early resolution of valuation disputes, reduce operational risk, and increase operational efficiency.

Conversely, multiple commenters objected to proposed § 23.502 on cost grounds. Some commenters argued that the rule would require significant investment in new infrastructure and some argued that the rule would have few benefits for SDs and MSPs that trade in shorter dated swaps.[90] Others asserted that portfolio reconciliation at the transactional level was only necessary if there are portfolio level discrepancies that result in margin disputes, and argued that routine reconciliation at the proposed frequency was unnecessarily costly.[91] Some argued that the swap portfolios of non-SDs, non-MSPs do not pose significant risk to the financial system and the rule may increase the costs of swaps for such entities.[92] Still others argued that the Commission must provide sufficient time for all registrants to develop the infrastructure required to meet the frequency of reconciliation required by the rule.

In relation to the one business day valuation dispute resolution requirement, many commenters stated that parties to a good-faith dispute should have a commercially reasonable timeframe in which to consult in order to find an appropriate resolution of the dispute. These commenters supported ISDA's 2011 Convention on Portfolio Reconciliation and the Investigation of Disputed Margin Calls and the 2011 Formal Market Polling Procedure, developed pursuant to industry commitments to the ODSG, which ISDA believes will be widely adopted by OTC derivatives market participants, and believed these industry efforts should play a more significant role in shaping the proposed reconciliation rules.[93] Other commenters argued that SDs and MSPs should not have to expend resources to resolve valuation disputes exceeding the proposed 10 percent threshold if they conclude that the discrepancy is not material in their particular circumstances.[94]

The Commission carefully considered each of the foregoing comments in formulating the final rule.

It should be noted that the Confirmation NPRM stated that the Commission anticipated that SDs and MSPs will be able to efficiently reconcile their internal records with their counterparties by reference to data in SDRs. The Commission received no comments disputing this assertion, and one commenter noted that SDRs would be in the best position to detect and manage discrepancies in the material terms of a swap transaction both efficiently and effectively.[95] The Commission has thus determined to adopt the portion of the rule that requires SDs and MSPs to reconcile the material terms of each swap in their swap portfolios in addition to reconciling the valuation of each swap but, at the urging of commenters, has reduced the required frequency of reconciliation to match the frequency of reconciliation currently undertaken by the largest prospective SDs.[96] The final rules require SDs and MSPs to reconcile portfolios with other SDs and MSPs at the following frequencies: daily for portfolios comprising 500 or more swaps; weekly for portfolios comprising 51 to 499 swaps; and quarterly for portfolios comprising one to 50 swaps. The Commission believes that the frequency of reconciliation of material terms and valuations of each swap required by the rule as modified will ensure the risk-reducing benefits of reconciliation by presenting a consolidated view of counterparty exposure down to the transaction level, and that these benefits are especially noteworthy when considered in light of the efficiencies possible through use of SDR data in the reconciliation process.

Having considered comments that the frequency of reconciliation with non-SD, non-MSP counterparties required by the rule was unnecessary to achieve the benefits of portfolio reconciliation outlined above, the Commission is also reducing the frequency of reconciliation required for non-registrant counterparties and is modifying the final rule to require reconciliation with such counterparties quarterly for swap portfolios of more than 100 swaps, and annually for all other swap portfolios. This level was recommended by commenters, including The Working Group.

With respect to the proposed rule's one business day deadline for valuation dispute resolution among SDs and MSPs, the Commission observes that daily valuation is critical for the appropriate operation of the Commission's proposed rules on margin, which is itself essential for the mitigation of risk posed by swaps. Issues related to swap valuations are woven through a number of Commission rule proposals. For instance, § 23.504(e), as adopted in this release, requires SDs and MSPs to report valuation disputes with SD or MSP counterparties in excess of $20,000,000 and lasting longer than three business days to the Commission, while under § 23.504(b)(4) SDs and MSPs are required to agree on valuation methodologies with their counterparties.

However, the Commission recognizes that valuation dispute resolution may be labor intensive and therefore costly. For this reason, the Commission modified the rule to provide for a five-day resolution process. In addition to this change, the Commission notes that, the costs of valuation dispute resolution are mitigated by the operation of several other parts of the new regulatory regime for swaps. First, the reconciliation requirements, and thus the valuation dispute resolution requirement, does not apply to cleared swaps, because DCOs establish settlement prices for each cleared swap every business day. It is likely that a large part of the swap

margin rules proposed by the OCC, the Federal Reserve Board, and the FDIC. *See* Margin and Capital Requirements for Covered Swap Entities, 76 FR 27564, 27589 (May 11, 2011).

[90] GFED.

[91] MFA; ISDA; The Working Group; MarkitSERV; AMG.

[92] Dominion; FHLBs; Chatham.

[93] ISDA; The Working Group; FHLBs; AMG.

[94] Chatham; The Working Group; MFA; ISDA.

[95] FHLBs.

[96] In December 2008, the ODSG's group of 14 major dealers committed to execute daily portfolio reconciliations for collateralized portfolios in excess of 500 trades between participating dealers by June of 2009. *See* June 2, 2009 summary of industry commitments, available at *http://www.isda.org/c_and_a/pdf/060209table.pdf*. As of May 2009, all participating dealers were satisfying this commitment. The ODSG dealers expanded their portfolio reconciliation commitment in March 2010 to include monthly reconciliation of collateralized portfolios in excess of 1,000 trades with any counterparty.

portfolios of SDs and MSPs will consist of cleared swaps [97] to which the reconciliation requirements will not apply; valuation disputes will therefore only arise in bilateral, uncleared portfolios. Second, the reconciliation requirements of § 23.503 are expected to avoid disputes from arising in the first instance through the regular comparison of material terms and valuations. Third, the Commission expects that § 23.504(b)(4), by requiring agreement with each counterparty on the methods and inputs for valuation of each swap, will assist SDs and MSPs to resolve valuation disputes within five business days.

SDs and MSPs need not resolve every valuation dispute, but only those where the difference in valuation is 10 percent or more. The Commission believes the 10 percent threshold is appropriate as it provides certainty as to which disputes must be resolved. The Commission believes the efficiency of a bright line rule, as opposed to the formulas and discretion in the alternatives suggested by commenters, will better serve the operational processes of SDs and MSPs and the regulatory oversight of the Commission. Thus, to maintain the risk mitigation benefits of the rule outlined above, the Commission has determined to retain the requirement that swap valuation disputes among SDs and MSPs be resolved within five business days.

As a further cost reduction measure, the Commission notes that it has extended the compliance dates for those SDs and MSPs that have not been previously regulated by a prudential regulator, and thus are least likely to have the infrastructure in place to begin regular reconciliation with their counterparties. As stated in section III.B.3 above, SDs and MSPs that have been previously regulated need not comply with the rule for three months after publication of the final rule in the **Federal Register**. SDs and MSPs that have not been previously regulated need not comply for six months after publication.

Finally, the Commission notes that ESMA has proposed portfolio reconciliation requirements that are substantially similar to those adopted by the Commission in this release.[98] By closely aligning portfolio reconciliation requirements through consultation with ESMA, the Commission believes that SDs and MSPs will benefit from a largely unitary regulatory regime that does not require separate compliance and operational policies and procedures.

D. Portfolio Compression

Portfolio compression is a mechanism whereby substantially similar transactions among two or more counterparties are terminated and replaced with a smaller number of transactions of decreased notional value in an effort to reduce the risk, cost, and inefficiency of maintaining unnecessary transactions on the counterparties' books. In many cases, these redundant or economically-equivalent positions serve no useful business purpose, but can create unnecessary risk,[99] as well as operational and capital inefficiencies.

The usefulness of portfolio compression as a risk management tool has been acknowledged widely. In 2008, the PWG identified frequent portfolio compression of outstanding trades as a key policy objective in the effort to strengthen the OTC derivatives market infrastructure.[100] Similarly, the 2010 staff report outlining policy perspectives on OTC derivatives infrastructure issued by the FRBNY identified trade compression as an element of strong risk management and recommended that market participants engage in regular, market-wide portfolio compression exercises.[101]

The value of portfolio compression also is illustrated by existing market participation in compression exercises. In March 2010, the Depository Trust and Clearing Corporation (DTCC) explicitly attributed the reduction in the gross notional value of the credit derivatives in its warehouse to industry supported portfolio compression.[102] TriOptima, which offers the TriReduce portfolio compression service, estimates that it terminated $106.3 trillion gross notional of interest rate swaps and $66.9 trillion gross notional of credit swaps between 2003 and 2010.[103] Similarly, Creditex and Markit, which offer portfolio compression exercises in single name credit default swaps, enabled participating institutions to eliminate $4.5 trillion in notional between late 2008 through 2009.[104]

In light of the recognized benefits of portfolio compression in reducing the risk, cost, and inefficiency of maintaining unnecessary transactions, the Commission proposed § 23.503, which required SDs and MSPs to participate in multilateral compression exercises that are offered by those DCOs or self-regulatory organizations of which the SD or MSP is a member, or as required by Commission regulation or order. The Commission also proposed that SDs and MSPs be required to terminate bilaterally all fully offsetting swaps between them by the close of business on the business day following the day the parties entered into the offsetting swap transaction and to engage annually in bilateral portfolio compression exercises with counterparties that are also SDs and MSPs to the extent that they have not participated in a multilateral compression exercise. Proposed § 23.503 did not require portfolio compression exercises for swaps outstanding between an SD or MSP and counterparties that are neither SDs nor MSPs. Instead, SDs and MSPs were required to establish written policies and procedures for periodically terminating all fully offsetting swaps and periodically engaging in compression exercises with such counterparties.

Several commenters supported the Commission's proposal and outlined the benefits of the approach. For instance,

[97] "It is expected that the standardized, plain vanilla, high volume swaps contracts—which according to the Treasury Department are about 90 percent of the $600 trillion swaps market—will be subject to mandatory clearing." 156 Cong. Rec. S5921 (daily ed. Jul. 15, 2010) (statement of Sen. Lincoln). The Tabb group estimates that 60–80 percent of the swaps market measured by notional amount will be cleared within five years of the time that the Dodd-Frank Act is implemented. *See* Tabb Group, "Technology and Financial Reform: Data, Derivatives and Decision Making."

[98] *See* ESMA Draft Technical Standards, Article 2 RM, subsection 4, (stating that "In order to identify at an early stage, any discrepancy in a material term of the OTC derivative contract, including its valuation, the portfolio reconciliation shall be performed: * * * each business day when the counterparties have 500 or more OTC derivative contracts outstanding with each other; * * * once per month for a portfolio of fewer than 300 OTC derivative contracts outstanding with a counterparty; * * * once per week for a portfolio between 300 and 499 OTC derivative contracts outstanding with a counterparty.").

[99] Federal Reserve Bank of New York Staff Report No. 424: "Policy Perspectives on OTC Derivatives Market Infrastructure," Jan. 2010 (revised Mar. 2010).

[100] "Policy Objectives for the OTC Derivatives Markets," President's Working Group on Financial Markets (Nov. 14, 2008).

[101] Federal Reserve Bank of New York Staff Report No. 424: "Policy Perspectives on OTC Derivatives Market Infrastructure," Jan. 2010 (revised Mar. 2010).

[102] DTCC Press Release, "DTCC Trade Information Warehouse Completes Record Year Processing OTC Credit Derivatives" (Mar. 11, 2010). Notably, beginning in August 2008, ISDA encouraged compression exercises for credit default swaps by selecting the service provider and defining the terms of service.

[103] *See www.trioptima.com.* Between 2007 and 2008, TriOptima reduced $54.7 trillion gross notional of interest rate swaps and $49.1 trillion gross notional of credit swaps. In March of 2010, the staff of the Federal Reserve Bank of New York estimated that since 2008 nearly $50 trillion gross notional of credit default swap positions has been eliminated through portfolio compression. Federal Reserve Bank of New York Staff Report No. 424: "Policy Perspectives on OTC Derivatives Market Infrastructure," Jan. 2010 (revised Mar. 2010).

[104] *See www.isdacdsmarketplace.com.*

Blackrock wrote in support of the Commission's proposal and encouraged the Commission to expand the proposal in order to achieve what Blackrock believes to be the essential benefits of compression. In addition, Eris Exchange wrote in support of compression and noted that it should lead to greater position netting and the ability to more freely unwind aged swap trades without having to go through a cumbersome novation process involving substantial operational burden and negotiated up-front payments.

On the other hand, multiple commenters objected to proposed § 23.503 on cost grounds. Some commenters argued that resource-intensive compression exercises should not be required in asset classes where there is not a high degree of transaction standardization and a high volume of redundant trades because the benefits would not outweigh the costs.[105] Similarly, many commenters argued that non-SD counterparties should not be included in any mandatory compression because such entities have portfolios with a very small number of offsetting transactions (i.e., almost all swaps are in the same market direction) and the cost of the exercise is not justified by the small benefit derived.[106] Other commenters noted that it is not cost effective to establish and run daily systems to monitor for fully offsetting swaps where there are likely to be none.[107] On another tack, some commenters argued against requiring participation in compression exercises offered by DCOs and SROs to avoid lack of competition and higher costs.

The Commission carefully reviewed the comments received with respect to proposed § 23.503 and considered each in formulating the final rule. Partly in response to the comments received regarding the costs imposed by the proposed rule, the Commission has revised the rule to reduce the cost burden on market participants. First, the Commission has determined to exclude swaps cleared by a DCO from the rule. As noted above, each DCO is required to establish portfolio compression procedures, but participation in such compression exercises by clearing members is voluntary. Accordingly, the revisions to § 23.503 are consistent with the revised DCO final rules with respect to cleared swaps. Second, the Commission was persuaded that the benefits of the rule could be maintained without requiring SDs and MSPs to incur the costs of mandatory compression. Thus, as discussed in more detail above, the Commission is electing to adopt the alternative suggested by commenters and is modifying the rule to replace the mandatory compression requirement with a requirement that SDs and MSPs establish policies and procedures for periodically engaging in portfolio compression exercises with counterparties that are also SDs or MSPs and for engaging in portfolio compression with all other counterparties upon request. The Commission is qualifying the requirement that SDs and MSPs terminate fully offsetting swaps by requiring instead that SDs and MSPs establish policies and procedures for terminating fully offsetting swaps in a timely fashion, but allowing SDs and MSPs to determine where it is appropriate to do so. The Commission believes that these modifications retain the benefits of portfolio compression while reducing the compliance costs to SDs and MSPs and costs that otherwise may have been incurred by other market participants.

Finally, the Commission notes that ESMA has proposed portfolio compression requirements that are substantially similar to those adopted by the Commission in this release.[108] By closely aligning portfolio compression requirements through consultation with ESMA, the Commission believes that SDs and MSPs will benefit from a largely unitary regulatory regime that does not require separate compliance and operational policies and procedures.

E. Swap Trading Relationship Documentation

The OTC derivatives markets traditionally have been characterized by privately negotiated transactions entered into by two counterparties, in which each party assumes and manages the credit risk of the other. While OTC derivatives are traded by a diverse set of market participants, such as banks, hedge funds, pension funds, and other institutional investors, as well as corporate, governmental, and other end-users, a relatively few number of dealers are, by far, the most significantly active participants. As such, the default of a dealer may result in significant losses for the counterparties of that dealer, either from the counterparty exposure to the defaulting dealer or from the cost of replacing the defaulted trades in times of market stress.[109]

OTC derivatives market participants typically have relied on the use of industry standard legal documentation, including master netting agreements, definitions, schedules, and confirmations, to document their swap trading relationships. This industry standard documentation, such as the widely used ISDA Master Agreement and related definitions, schedules, and confirmations specific to particular asset classes, offers a framework for documenting the transactions between counterparties for OTC derivatives products.[110] The standard documentation is designed to set forth the legal, trading, and credit relationship between the parties and to facilitate cross-product netting of transactions in the event that parties have to close-out their position with one another.

One important method of addressing the credit risk that arises from OTC derivatives transactions is the use of bilateral close-out netting. Parties seek to achieve enforceable bilateral netting by documenting all of their transactions under master netting agreements.[111] Following the occurrence of a default by one of the counterparties (such as bankruptcy or insolvency), the exposures from individual transactions between the two parties are netted and consolidated into a single net ''lump sum'' obligation. A party's overall exposure is therefore limited to this net sum. That exposure then may be offset by the available collateral previously provided being applied against the net exposure. As such, it is critical that the netting provisions between the parties are documented and legally enforceable and that the collateral may be used to meet the net exposure. In recognition of the risk-reducing benefits of close-out netting, many jurisdictions provide favorable treatment of netting

[105] ISDA; The Working Group; Markit.

[106] TriOptima; Markit; ISDA; ABC & CIEBA; AMG; Chatham; Dominion; FHLBs; Freddie Mac; MetLife; MFA; NAIC; GFED.

[107] The Working Group.

[108] *See* ESMA Draft Technical Standards, Article 3 RM, subsection 2, (stating that ''counterparties with 500 or more OTC derivative contracts outstanding which are not centrally cleared shall have procedures to regularly, and at least twice a year, analyse the possibility to conduct a portfolio compression exercise in order to reduce their counterparty credit risk and engage in such portfolio compression exercise.'').

[109] *See* Financial Stability Board, ''Implementing OTC Derivatives Market Reforms: Report of the OTC Derivatives Working Group,'' (Oct. 10, 2010), available at *http://www.financialstabilityboard.org/publications/r_101025.pdf.*

[110] The International Swaps and Derivatives Association (ISDA) is a trade association for the OTC derivatives industry (*http://www.isda.org*).

[111] Enforceable bilateral netting arrangements are a common commercial practice and are an important part of risk management and minimization of capital costs.

arrangements in bankruptcy,[112] and favorable capital and accounting treatment to parties that have enforceable netting agreements in place.[113]

There is also a risk that inadequate documentation of open swap transactions could result in collateral and legal disputes, thereby exposing counterparties to significant counterparty credit risk. By way of contrast, adequate documentation between counterparties offers a framework for establishing the trading relationship between the parties.

To ensure the risk-reducing benefits of adequate swap trading relationship documentation, the Commission proposed § 23.504. Proposed § 23.504 required SDs and MSPs to establish, maintain, and enforce written policies and procedures reasonably designed to ensure that each SD and MSP and its counterparties have agreed in writing to all of the terms governing their swap trading relationship and have executed all agreements required by proposed § 23.504. These included agreement on terms related to payment obligations, netting of payments, events of default or other termination events, netting of obligations upon termination, transfer of rights and obligations, governing law, valuation, and dispute resolution procedures, as well as credit support arrangements, including margin and segregation. Agreement on valuation methodologies pursuant to § 23.504(b)(4) is discussed separately below. In addition, proposed § 23.504 required each SD and MSP to have an independent internal or external auditor examine annually at least 5 percent of the swap trading relationship documentation created during the year to ensure compliance with Commission regulations and the SD's or MSP's policies and procedures established pursuant to § 23.504.

Several commenters supported the rule. One stated that clear and thorough standards for documentation are essential to avoid the situation that became apparent when AIG and Lehman Brothers failed: A hopelessly tangled web of poorly documented transactions, with the effort to sort it all out emerging as a separate threat to the financial system.[114] Others supported the goal of the rule to ensure that the parties to a trade have in fact agreed on its economic and legal terms prior to or contemporaneously with entering into a swap, and are communicating and maintaining appropriate records memorializing that agreement.[115] However, many commenters also objected to the proposed rule on cost grounds.

Several commenters strongly urged the Commission not to make § 23.504 retroactively applicable to existing swaps because the need to make amendments to existing documentation would be time consuming and costly.[116] Having considered these comments, the Commission is adopting the alternative presented by commenters and is modifying § 23.504 to make clear that the rule does not apply to swaps executed prior to the date on which SDs and MSPs are required to be in compliance with § 23.504. The Commission notes, however, that the rule does not prohibit SDs and MSPs from agreeing with their counterparties to amend existing swap trading relationship documentation to bring such documentation into compliance with § 23.504 (or any other Commission regulation) and ensure that netting arrangements will apply to swaps executed prior to and after promulgation of § 23.504. The ability to combine netting sets in this manner may reduce costs of collateralization for many SDs and MSPs.

Several commenters were concerned that proposed § 23.504 may require market participants to incur the burden and expense of negotiating master agreements even if a stand-alone agreement or ''long-form'' confirmation that incorporates terms of a standard master agreement by reference would sufficiently address legal risks.[117] The Commission notes, however, that nothing in the rule prohibits incorporation by reference so long as the terms so incorporated are in written form, and therefore confirms that so long as a ''long-form'' confirmation includes all terms of the trading relationship and is executed prior to or contemporaneously with entering into a swap transaction, such would be in compliance with § 23.504.

A number of comments reflected a concern regarding the requirement that SDs and MSPs audit no less than 5 percent of their trading relationship documentation annually, arguing that the requirement is burdensome and recommending that the Commission adopt an alternative, principles-based approach requiring SDs and MSPs to conduct audits sufficient to identify material weaknesses in their documentation policies and procedures. The Commission was persuaded that the audit requirement need not prescribe the percentage of agreements to be audited to maintain the benefits of the rule, and has modified the rule in accordance with the recommendations of commenters.

In addition, several commenters recommended that valuation dispute reporting under § 23.504(e) should be subject to a materiality standard to avoid an overly-burdensome reporting requirement that will result in substantial informational noise. The Commission agreed with these commenters and reduced the burden of the reporting requirement by revising the proposed rule to add a $20,000,000 threshold on the reporting of valuation disputes.

Finally, the Commission recognizes that requiring implementation of the documentation requirements of § 23.504 immediately or within a very compressed timeframe creates certain costs for industry participants. Consequently, reducing these costs—enumerated below—by extending the compliance schedule represents a benefit.

First, to meet timelines some firms will need to contract additional staff or hire vendors to handle some necessary tasks or projects. Additional staff hired or vendors contracted in order to meet more pressing timelines represent an additional cost for market participants. Moreover, as pointed out by commenters, a tightly compressed timeframe raises the likelihood that more firms will be competing to procure services at the same time; this could put firms that conduct fewer swaps at a competitive disadvantage in obtaining those services, making it more difficult for them to meet required timelines.[118] In addition, it could enable service providers to command a pricing premium when compared to times of ''normal'' or lesser competition for similar services. That premium represents an additional cost when compared to a longer compliance timeline.

Second, if entities are not able to comply with the documentation requirements by a certain date, they may avoid transacting swaps requiring compliance until such a time as they are able to comply. In this event, liquidity

[112] *See e.g.,* 11 U.S.C. 561 (protecting contractual right to terminate, liquidate, accelerate, or offset under a master netting agreement and across contracts).

[113] *See* 12 CFR part 3, Appendix C; 12 CFR part 208, Appendix F; 12 CFR part 225, Appendix G; and 12 CFR part 325, Appendix D (banking regulations regarding qualifying master netting agreements).

[114] Better Markets.

[115] ISDA & SIFMA.

[116] The Working Group; ISDA & SIFMA; FSR; MFA; FHLBs; The Coalition for Derivative End-Users.

[117] OCC; IECA.

[118] *See* letter from CIEBA.

that otherwise would result from those foregone swaps would be reduced, making the swaps more expensive for market participants taking the other side. Moreover, firms compelled to withdraw from the market pending compliance with required documentation measures will either leave certain positions un-hedged—potentially increasing the firm's own default risk, and therefore the risk to their counterparties and the public. Alternatively, firms compelled to withdraw from the market for a period of time could attempt to approximate their foregone swap hedges using other, likely more expensive, instruments. Further, to the extent the withdrawing entities are market makers, they will forsake the revenue potential that otherwise would exist for the period of their market absence.

Third, firms may have to implement technological solutions, sign contracts, and establish new operational procedures before industry standards have emerged that address new problems effectively. To the extent that this occurs, it is likely to create costs. Firms may have to incur additional costs later to modify their technology platforms and operational procedures further, and to renegotiate contracts—direct costs that a more protracted implementation schedule would have avoided.[119] Moreover, costs created by the adoption of standards that fail to address certain problems, or attributable to undesired competitive dynamics resulting from such standards, may be longstanding.

The Commission, informed by its consideration of comments and alternatives, discussed in the sections above and below, believes that the approach contained in this adopting release is reasonable and appropriate in light of the tradeoffs described above. The compliance dates discussed above give the Commission the opportunity to provide additional time to entities in ways that generally align with: (1) Their resources and expertise, and therefore their ability to comply more quickly; and (2) their level of activity in the swap markets, and therefore the possible impact of their swap activities on the stability of the financial system. Entities with the most expertise in, and systems capable to transact, swaps also are likely to be those whose transactions represent a significant portion of all transactions in the swap markets. They are more likely to be able to comply quickly, and the benefits of requiring them to do so are greater than would be the case for less active entities. On the other hand, entities with less system capability and in-house swap expertise may need more time to comply with documentation requirements, but it is also likely that their activities represent a smaller proportion of the overall market, and therefore are less likely to create or exacerbate shocks to the financial system.[120] The Commission believes that SDs, security-based swap dealers, MSPs, major security-based swap participants, and active funds (as defined above) are entities likely possessing more advanced systems and expertise, and whose swap activities constitute a significant portion of overall swap market transactions. On the other hand, other market participants may be less likely to have highly developed infrastructure and likely have swap activities that constitute a less significant proportion of the market. Therefore, the Commission has determined to stagger the compliance dates for § 23.504, providing 90, 180, or 270 days for SDs and MSPs to bring their swap trading relationship documentation into compliance with the rules, depending on the identity of the counterparty as discussed more fully in section III.B.1 above.

F. Swap Valuation Methodologies

Swap valuation disputes have long been recognized as a significant problem in the OTC derivatives market.[121] The ability to determine definitively the value of a swap at any given time lies at the center of many of the OTC derivatives market reforms contained in the Dodd-Frank Act and is a cornerstone of risk management. Swap valuation is also crucial for determining capital and margin requirements applicable to SDs and MSPs and therefore plays a primary role in risk mitigation for uncleared swaps.

The Commission recognizes that swap valuation is not always an easy task. In some instances, there is widespread agreement on valuation methodologies and the source of formula inputs for frequently traded swaps. Many of these swaps have been accepted for clearing for a number of years (i.e., commonly traded interest rate swaps and CDS). However, parties often dispute valuations of thinly traded swaps where there is not widespread agreement on valuation methodologies or the source for formula inputs. Many of these swaps are thinly traded either because of their limited use as risk management tools or because they are simply too customized to have comparable counterparts in the market. As many of these swaps are valued by dealers internally by ''marking-to-model,'' their counterparties may dispute the inputs and methodologies used in the model. As uncleared swaps are bilateral, privately negotiated contracts, on-going swap valuation for purposes of initial and variation margin calculation and swap terminations or novations, has also been largely a process of on-going negotiation between the parties. The inability to agree on the value of a swap became especially acute during the 2007–2009 financial crisis when there was widespread failure of the market inputs needed to value many swaps.[122]

In light of these concerns, the Commission proposed § 23.504(b)(4), which required SDs and MSPs to include in their swap trading relationship documentation an agreement with their counterparties on the methods, procedures, rules, and inputs for determining the value of each swap at any time from execution to the termination, maturity, or expiration of such swap. The Commission believes that by requiring agreement between counterparties on the methods and inputs for valuation of each swap, § 23.504(b)(4) will assist SDs and MSPs and their counterparties to arrive at valuations necessary for margining and internal risk management, and to resolve valuation disputes in a timely manner, thereby reducing risk.

[119] *See* e.g., ACLI letter.

[120] OCC data demonstrates that among insured US commercial banks, ''the five banks with the most derivatives activity hold 96 percent of all derivatives, while the largest 25 banks account for nearly 100 percent of all contracts.'' The report is limited to insured US commercial banks, and also includes derivatives that are not swaps. However, swap contracts are included among the derivatives in the report, constituting approximately 63 percent of the total notional value of all derivatives. These statistics suggest that a relatively small number of banks hold the majority of swap positions that could create or contribute to distress in the financial system. Data is insufficient, however, to generalize the conclusions to non-banking institutions. *See* ''OCC's Quarterly Report on Bank Trading and Derivatives Activities: Fourth Quarter 2011'' p. 11. *http://www.occ.treas.gov/topics/capital-markets/financial-markets/trading/derivatives/dq411.pdf.*

[121] *See* ISDA Collateral Committee, ''Commentary to the Outline of the 2009 ISDA Protocol for Resolution of Disputed Collateral Calls,'' June 2, 2009 (stating ''Disputed margin calls have increased significantly since late 2007, and especially during 2008 have been the driver of large (sometimes > $1 billion) un-collateralized exposures between professional firms.'').

[122] The failure of the market to set a price for mortgage-backed securities led to wide disparities in the valuation of CDS referencing mortgage-backed securities (especially collateralized debt obligations). Such wide disparities led to large collateral calls from dealers on AIG, hastening its downfall. *See* CBS News, ''Calling AIG? Internal Docs Reveal Company Silent About Dozens Of Collateral Calls,'' Jun. 23, 2009, available at: *http://www.cbsnews.com/stories/2009/06/23/cbsnews_investigates/main5106672.shtml.*

Commenters supported the valuation proposal in light of the benefits to risk management and adequate collateralization.[123] Indeed, some commenters argued that the Commission should have been more prescriptive in its approach to valuation.

Multiple commenters, however, objected to § 23.504(b)(4) on cost grounds. Specifically, commenters stated that the rule will significantly increase the pre-execution swap negotiation burden on SDs, MSPs, and their counterparties without an offsetting benefit.[124] Some commenters also objected that the rule may discourage the development of more refined, dynamic swap valuation models that are more accurate, and therefore more efficient, than less sophisticated or vanilla models.[125]

Other commenters offered alternatives to requiring SDs and MSPs to agree on valuation methodologies with their counterparties. Many recommended that the Commission focus its rules on the valuation dispute resolution process, rather than valuation methodologies.[126] One recommended that the rule include an explicit authorization for parties to use the services of independent third parties to provide any or all of the elements required to agree upon the valuation of swaps, and not include any preferable inputs or pricing sources for the valuation of swaps.[127] Another recommended that the rule be deleted and replaced with a requirement that SDs and MSPs provide information to substantiate their valuations upon the request of a counterparty.[128]

As discussed above, the Commission is substantially modifying the rule in response to concerns raised and alternatives suggested by commenters. Many of the changes being made in the rule adopted by this release address the cost concerns and alternatives outlined above. First, the rule has been focused on the valuation needed to meet the margin requirements under section 4s(e) of the CEA and the Commission's regulations under part 23, and to meet the risk management requirements under section 4s(j) of the Act and the Commission's regulations under part 23. The Commission believes that this change, by focusing the use of the agreed-upon valuation methodologies, will ease pre-execution negotiation and improve internal risk management processes. In addition, the Commission responded to concerns from market participants who feared they would have to agree on precise models, by clarifying that they had to agree on a process, which includes things such as methods, procedures, rules and inputs. Parties are free to agree on a model, agree to use one party's confidential proprietary model, rely on third-party vendors, or a host of other possibilities.

Second, the rule has been modified such that SDs and MSPs need not agree on swap valuation methodologies with counterparties that are not SDs, MSPs, or financial entities, unless such counterparties request such agreements. The Commission believes that this change will alleviate the pre-execution negotiation burden on SDs, MSPs, and their non-financial entity counterparties by limiting such negotiations to counterparties that are more likely to use sophisticated valuation methodologies akin to those in use by the SD or MSP itself.

Third, in response to commenters that objected that the rule may discourage the development of more refined, dynamic swap valuation models that are more accurate, and therefore more efficient, than less sophisticated or vanilla models, the Commission is modifying the rule to explicitly permit parties to agree on changes or procedures to modify their valuation agreements at any time. This change allows counterparties to determine an efficient means of changing the agreement for each contract to allow for evolution of valuation methodologies while maintaining the benefits of agreed-upon valuation methodologies.

Fourth, in response to commenters' concerns regarding the protection of proprietary information used in valuation, the Commission is modifying the rules to make explicit that SDs and MSPs are not required to disclose to the counterparty confidential, proprietary information about any model it may use to value a swap. The Commission believes this clarification will alleviate concerns that proprietary information would have to be disclosed as a result of the valuation agreement process.

Finally, the rule has been modified to allow for use of a valuation dispute resolution process in place of the proposed requirement that the documentation include alternative methods for determining the value of a swap in the event of the unavailability or failure of any input required to value the swap. The Commission believes this change lessens the negotiation and operational burden on SDs and MSPs.

The Commission believes that the changes outlined above substantially reduce the burden of the rule on SDs, MSPs, and their counterparties without sacrificing the benefits of the rule. The rule will serve to assist SDs and MSPs and their counterparties in arriving at valuations necessary for margining and internal risk management, and in resolving valuation disputes in a timely manner, thereby reducing risk.

G. Summary of Cost and Benefit Considerations: Confirmation, Portfolio Reconciliation, and Portfolio Compression

In the Confirmation NPRM, the Commission specifically requested comment on its consideration of costs and benefits. The Commission received a number of comments in addition to those discussed above.

ISDA commented that registrants will incur substantial initial one-time costs to develop, test, and implement new procedures and technology that are required in order to be compliant with the proposed rules. With regard to confirmation costs, ISDA asserted that market participants will have to invest in electronic platforms for confirmation for each asset class in order to meet the expedited timeframes for confirmation, which may be prohibitively expensive, particularly for non-SDs and non-MSPs. However, ISDA did not provide any quantitative data in support of this assertion despite multiple requests from Commission staff.[129]

ISDA also argued that given the marked improvement in post-trade processing, as well as continued industry efforts and commitments to enhance post-trade processing in a targeted, efficient and safe manner, it is unclear whether the incremental benefits of the Commission's proposed standards applicable to all swap confirmations will outweigh the significant compliance costs that the confirmation requirements will entail.

To comply with the portfolio reconciliation requirement promptly, ISDA believes firms that do not currently use an electronic platform or vendor service will need to expend significant time and resources, and even those firms that do use electronic platforms or vendor services to reconcile their portfolios will need to make significant adjustments to comply with the reconciliation requirement. ISDA believes that initial compliance

[123] Better Markets; Michael Greenberger; Chris Barnard.

[124] The Working Group; ISDA & SIFMA; FSR; Markit; Freddie Mac; COPE; MFA; FHLBs; CIEBA; EEI; Coalition of Derivatives End-Users. Several of these commenters stated that such pre-execution negotiations could take months to complete, if possible at all.

[125] OCC; Hess.

[126] The Working Group; Morgan Stanley; MFA; IECA; FHLBs; CIEBA; MetLife.

[127] Markit.

[128] Coalition of Derivatives End-Users.

[129] *See* cftc.gov for information regarding staff meetings with ISDA pertaining to these final rules.

with the proposed rules will cost each entity approximately $5–10 million and annual portfolio reconciliation expenses for a party with a large portfolio may rival and perhaps even exceed this upfront cost.

The Working Group requested that the Commission address any requirement for electronic matching of all or certain types of swaps in a separate rulemaking that includes a careful study of the potential costs imposed by such a rule. The Working Group estimated, based on the $6.00 per trade fee of the ICE eConfirm service, that implementation of an electronic matching requirement would cost each registrant in excess of $1,000,000 annually. In addition, The Working Group asserted that there would be additional opportunity costs associated with no longer being able to enter into customized transactions.

The Working Group requested that the Commission evaluate the proposed rules in light of its various recordkeeping and reporting proposals, as such may cause firms to incur tremendous administrative obligations to record changes to their swap portfolios, their accounting records, treasury arrangements and capital allocations, as well as incurring reporting obligations to SDRs on a swap-by-swap basis. The Working Group also presented a report prepared by NERA estimating that compliance with the proposed rules for some entities in this category would entail annual incremental costs of $1,400,000.[130]

The FHLBs cautioned that SD compliance with the proposed rules could adversely impact end users in a number of ways, including (i) SD unwillingness to offer swaps important to end user risk management if the SD cannot comply with the rules in an economic manner; (ii) passing on of SD compliance costs to end user counterparties, discouraging some end users from using cost-effective risk management tools and raising overall system risk; and (iii) introduction of legal uncertainty as to the enforceability of swaps that fail to meet the confirmation deadlines of the proposed rules. The FHLBs also argued that certain swap documentation requires review by legal staff and the short deadline for confirmation would require pre-execution review by legal staff, even for swaps that are discussed but never actually executed, entailing costly and unnecessary legal expenditures.

As discussed in the above sections, the Commission has modified many aspects of the proposed rules in order to mitigate the burden placed on market participants as identified by commenters while still achieving the important policy goals outlined above. The Commission has:

- Provided for a phased implementation plan, providing longer periods for compliance with the rule for those entities for which the rules will be most burdensome, with particularly long phasing of confirmation deadlines;[131]
- Expanded the definition of ''multilateral portfolio compression exercise'' which increases flexibility of the rule;
- Removed the 15 and 30 minute acknowledgement and confirmation deadlines for swap transactions that are ''processed electronically'';
- Required draft trade acknowledgements only to be delivered upon request of a counterparty prior to execution;
- Adjusted confirmation deadlines for time zone differences and end of day trading, providing relief from more stringent deadlines;
- Provided a safe harbor from confirmation requirements for swaps executed on a SEF or DCM, or cleared by a DCO;
- Clarified which swap transactions require confirmation;
- Reduced the frequency of required portfolio reconciliation with non-SDs and MSPs;
- Changed the valuation dispute resolution requirement from ''one business day'' to ''policies and procedures reasonably designed to ensure that valuation disputes are resolved within five business days;''
- Required portfolio compression with non-SDs and non-MSPs only upon request of the non-SD or non-MSP counterparty;
- Changed the mandatory portfolio compression requirement among SDs and MSPs to a requirement for policies and procedures for engaging in regular portfolio compression, where appropriate;
- Required fully-offsetting swaps to be terminated in a timely fashion (rather than within one business day) and only where appropriate; and
- Clarified that the compression rule does not apply to cleared swaps; compression of cleared swaps will be in accordance with the rules of the DCO.

Through these changes, the Commission anticipates that many of the concerns raised by commenters regarding the costs of the rules will be mitigated.

Confirmation. The Commission anticipates that there will be a significant adjustment for market participants to move to the faster timeframes required by the confirmation rules, particularly in those asset classes where the majority of transactions are manually confirmed. SDs and MSPs will have to design, compose, and implement policies and procedures reasonably designed to meet the confirmation timeframes; SDs and MSPs must also compile and maintain any applicable records. Participants may invest in electronic platforms for confirmation for each asset class in order to meet the expedited timeframes for confirmation. The Commission notes, however, that such investment is not necessarily required by the rules as market participants are able to confirm in any manner that meets the rule's deadline of the first business day after the day of execution (or two-business day timeframe, for swap transactions with non-financial non-registrants).

With regard to confirmation, the historical context reveals that market participants, including all major swap dealers, have been working on achieving timely confirmation across all asset classes for the past 5–7 years. Consequently, additional costs related to confirmation technology for these entities would be minimal for those SDs and MSPs already achieving timely confirmation of their swap transactions. In addition, costs will be further minimized through a significant phase-in period. For example, SDs and MSPs will have up to two years to achieve compliance with the rules.

Moreover, the Commission has sought to gather additional information about the costs of confirmation services from both ISDA and major third party service providers of confirmation services. Commission staff meetings with third party service providers have revealed that per trade or event confirmations can cost anywhere from $3 to $10 per transaction. It should be noted, however, that confirmation fee schedules can be complex and dependent on a host of idiosyncratic factors.

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[130] NERA, Cost-Benefit Analysis of the CFTC's Proposed Swap Dealer Definition Prepared for the Working Group of Commercial Energy Firms, December 20, 2011. In the late-filed comment supplement, NERA estimates these costs for entities ''engaged in production, physical distribution or marketing of natural gas, power, or oil that also engage in active trading of energy derivatives''—termed ''nonfinancial energy companies'' in the report. The figure cited includes costs to comply with the proposed confirmation, portfolio reconciliation, and portfolio compression requirements and is based on the survey response of only one member of The Working Group. Elsewhere in the same report, NERA estimates the costs of compliance with the confirmation requirements alone at $235,000 for initial set-up and annual operating costs of $307,000.

[131] This alternative was suggested by both ISDA and The Working Group, and the Commission has adopted it for these final rules.

The Commission notes The Working Group's estimate of approximately $1,000,000 per entity to implement an electronic matching requirement, but observes that the deletion of the phrase ''processed electronically'' from the rules should make clear to market participants that there is no requirement to confirm electronically. However, this estimate may be useful for individual entities to use as a reference figure for investment in electronic platforms.[132]

The Commission is unable to provide more specific quantification of the costs of confirmation given the unique characteristics of the swap portfolios of SDs, MSPs, and their counterparties, as well as the parties' discretion in choosing how to comply with the confirmation timeframe.

As noted above, the Commission does not believe the rules requiring SDs and MSPs to have policies and procedures to achieve confirmation with their non-registrant counterparties should pose an unreasonable burden on end users. The Commission extended the confirmation deadline for non-financial, non-registrant counterparties to two business days after execution, lessening the rush to review and approve acknowledgements and/or confirmations while maintaining a relatively quick turn-around for these market participants. In addition, the Commission anticipates that the changed provisions regarding draft acknowledgements and compression—which give the non-SD or MSP counterparty the option as opposed to obligation—should ensure that such entities are protected from unfair practices without overburdening the operations of these entities.

The benefits associated with quicker confirmation, as noted in sections III.C and IV.B of this release, include improvement of post-execution operational and risk management processes, including the correct calculation of cash flows and discharge of settlement obligations as well as accurate measurement of counterparty credit exposure. Timely confirmation also allows any discrepancies, exceptions, and/or rejections of terms to be identified and resolved more quickly, lessening the risk of a dispute that could disrupt orderly market operations. In general, the rules regarding expedited confirmation should improve the efficient and orderly operations of bilateral markets through more effective risk management and dispute resolution. The extended compliance timeframes should allow for a smooth transition to the new rules as market participants prepare not only to meet these standards, but others imposed by new regulations under the Dodd-Frank Act.

Reconciliation. In response to ISDA's concern that the reconciliation rules would require significant investment in electronic platforms for reconciliation, especially for those entities with large portfolios, the Commission reiterates its view that the advent of SDRs will eventually ease some of those costs by providing a central data location for most (if not all) the material terms that are required to be reconciled.

Importantly, the Commission has not determined which processes for reconciliation are the most appropriate, which means that each market participant can choose the method for reconciliation that best fits its own internal structure and cost-benefit analysis, provided such method comports with the Commission's requirements. In addition, the changes listed above—including the reduced frequency of reconciliation for portfolios between SDs or MSPs and their non-SD or non-MSP counterparties—should ease the burden of reconciling portfolios. While the Commission has been unable to independently verify the $5–10 million estimate for portfolio reconciliation provided by ISDA, the Commission expects that the changes herein as well as the increased use of SDRs will lessen the estimated cost considerably.

In the Confirmation NPRM, the Commission asserted that the costs of the proposed rules would be minimized by the fact that most SDs and MSPs reconcile their swap portfolios as part of a prudent operational processing regime that many, if not most, SDs and MSPs already undertake as part of their ordinary course of business. In response to these assertions, at least one commenter agreed that a large number of SDs and MSPs already regularly reconcile their portfolios with each other and with other entities and that the increased frequency and inclusion of smaller portfolios as proposed should prove no obstacle to such entities.[133] Consequently, additional costs of the Commission's final rule would be minimal for those SDs and MSPs already engaged in regular portfolio reconciliation. In addition, the Commission's decision to extend the valuation dispute resolution requirement from one day responds to concerns from market participants about cost.

Given the widespread benefits of portfolio reconciliation, including increased risk management and fewer disputes to resolve, the Commission believes its final rules regarding reconciliation are appropriate notwithstanding the increased costs for some participants. The Commission recognizes that certain costs will still arise despite the changes the Commission has made. Such costs include (i) Increased costs to include all material terms rather than some subset of terms; (ii) the additional resources to design, compose, and implement the required policies and procedures; (iii) the additional resources needed to comply with the dispute resolution timeframes; and (iv) the compilation and maintenance of applicable records. These costs, however, are by nature specific to each entity's internal operations; absent specific cost estimates from commenters (which were not provided), the Commission cannot accurately provide estimations regarding the resources needed to comply. As stated above and in the NPRM, portfolio reconciliation is widely recognized as an effective means of identifying and resolving disputes regarding terms, valuation, and collateral. Reconciliation is beneficial not only to the parties involved but also to the markets as a whole. By identifying and managing disputed key economic terms or valuation for each transaction across a portfolio, overall risk can be diminished. Registrants will be able to identify and correct problems in their post-execution processes (including confirmation) in order to reduce the number of disputes and improve the integrity and efficiency of their internal processes. Expanding the universe of participants subject to reconciliation, therefore, can help to reduce the risk bilateral markets may pose to the broader financial system.

Compression. Finally, the Commission believes its final rules regarding portfolio compression dramatically reduce costs as compared to the proposed rule; however, the Commission recognizes that costs will necessarily increase from the current state of the market. Participants will necessarily have to design, compose, and implement policies and procedures to regularly evaluate compression opportunities with their counterparties as well as those opportunities offered by third parties. However, given the large risk management benefits available from the regular compression of offsetting trades—benefits including reduced risk

[132] The Commission also notes the estimates provided by NERA, but observes that NERA did not provide sufficient information for the Commission to determine which portion of such estimates assumed implementation of an electronic matching requirement. Thus the Commission could not independently verify the estimates.

[133] TriOptima letter.

and enhanced operational efficiency—the Commission believes the final rules are appropriate to ensure the fair and orderly operation of bilateral derivatives markets.

In terms of quantification of the costs of compression, the Commission notes that in its Confirmation NPRM, it stated that there are a number of third-party vendors that provide compression, and some of these providers charge fees based on results achieved (such as number of swaps compressed). No commenter refuted this statement or provided alternative information regarding quantification.

H. Section 15(a) Considerations: Confirmation, Portfolio Reconciliation, and Portfolio Compression

1. Protection of Market Participants and the Public

The final rules relating to confirmation, portfolio reconciliation, and portfolio compression protect market participants by improving operational efficiency and mitigating legal risk. In turn, the reduction of risk in bilateral markets can reduce risk across the interconnected financial system, protecting the public from costly market disruptions.

Timely confirmation protects market participants by providing certainty as to obligations between SDs, MSPs, and their counterparties while allowing a more efficient processing of disputed terms that may become apparent during the confirmation process. Disputes regarding terms and conditions, when left unresolved, can expose market participants to significant counterparty credit risk. By diminishing the number of these disputes that occur and by decreasing the length of time in which they are resolved, the Commission believes these rules protect participants from such unnecessary risk.

2. Efficiency, Competitiveness, and Financial Integrity of Derivatives Markets

The final rules improve the efficiency of the market by decreasing the amount of time trades remain outstanding, improving the processes by which trades are confirmed, and requiring participants to eliminate unnecessary trades. Trades that remain unconfirmed for extended periods of time create inefficient backlogs that inhibit the orderliness of the market. Proper confirmation, compression, and reconciliation policies improve transparency in the market and increase efficiency by promoting the exchange of important market information. Requirements regarding confirmations and draft acknowledgements, as discussed above, provide non-financial entities with information necessary for confirming promptly. In addition, such draft acknowledgements may serve counterparties insofar as they might compare and assess counterparties, which should improve competition among SDs and MSPs.

3. Price Discovery

The timeliness of confirmations, as required under these rules, should ensure that all terms including prices of transactions are agreed upon quickly and efficiently. This linking of price terms with all other swap terms should improve the information provided to the public and regulators through SDRs and other means, thereby improving the overall price discovery process. Periodic reconciliation and compression also aid in ensuring that unnecessary and/or offsetting trades are netted and that, should disputes arise, those disputes are promptly and effectively resolved. In this way, the pricing information communicated regarding trades conducted under these rules should be accurate and timely, improving the price discovery function of bilateral derivatives markets.

4. Sound Risk Management

As described throughout this release, the rules promulgated herein are designed to mitigate the risk in bilateral derivatives markets by ensuring the timely and accurate confirmation of trades, reconciliation of portfolios, and compression of portfolios. The final rules require actions, policies, and procedures on the part of SDs and MSPs to diminish operational risk, legal risk, and counterparty credit risk. The Commission believes these requirements will encourage sound risk management on the part of SDs and MSPs; given the systemically important nature of these entities, sound risk management by SDs and MSPs should improve the risk management of the financial system as a whole, lessening the risks associated with a major market crisis.

5. Other Public Interest Considerations

The Commission has not identified other public interest considerations as a result of these rules.

I. Summary of Cost and Benefit Considerations: Swap Trading Relationship Documentation

The Commission requested comment on its consideration of costs and benefits under section 15(a) of the CEA. The Commission received a number of responsive comments in addition to those discussed above.

The Working Group stated that the Commission should articulate the public policy benefit of the proposed rule and present analysis that demonstrates such benefit exceeds the cost imposed on market participants and the Commission. IECA stated that the proposed regulations would impose administrative and regulatory costs in excess of any benefit gained. The Coalition for Derivatives End Users was concerned that the valuation provision will increase costs without a proportionate benefit. Markit stated that the proposed rule will make the process of transaction documentation very expensive and time consuming, and will lead to extremely technical and verbose swap documentation, noting that the need to negotiate such terms may impede effective trading. Markit thus believes the costs outweigh the benefits, and urges the Commission to impose more realistic requirements regarding valuation methodologies.

IECA believes the Commission's cost-benefit analysis did not consider the legal review and management time expense for end users, which could be significant for small entities. IECA focuses on the Commission's estimates under the Paperwork Reduction Act, and challenges the Commission's use of $125 per hour for legal fees. IECA believes that $500 an hour is more appropriate for legal fees. IECA also believes that the Commission's estimate of an average of 10 hours per counterparty to negotiate the new documentation under § 23.504(b) is low, as the time needed must include not only negotiation, but also time for determining price points and inputs, decision-making time, and senior management time.

The Working Group believes the Commission's implementation costs substantially underestimate the potential impact because: (i) Margin requirements have yet to be proposed and negotiation of credit support arrangements currently can take months; (ii) market participants are unlikely to agree to standardized valuation methodologies; (iii) the Commission does not specifically discuss the potentially substantial costs associated with the audit requirement under § 23.504(e); [134] and (iv) the

[134] The Working Group presented a report prepared by NERA estimating that compliance with the audit requirements in these and other proposed rules for some nonfinancial energy companies would entail annual incremental costs of $224,000. NERA, Cost-Benefit Analysis of the CFTC's Proposed Swap Dealer Definition Prepared for the Continued

proposed rules would significantly alter the process by which parties enter into swaps, and such costs have not been considered.

As discussed in the above sections, the Commission has modified many provisions of the final rules in response to comments received and in order to mitigate the burden imposed on market participants while accomplishing the goals as laid out in the NPRM. The Commission has:

• Provided for a phased implementation plan, providing longer periods for compliance with the rule for those entities for which the rules will be most burdensome;

• Clarified that the rules will be applicable only to swaps that are entered into after the rules become effective, and therefore not requiring retroactive application to existing swaps;

• Clarified that the rules do not apply to swaps executed on a SEF or DCM and cleared by a DCO, subject to certain minimum requirements;

• Imposed no additional requirements regarding documentation of events of default, termination events, or payment obligations;

• Permitted parties to agree on either alternative methods for determining the value of a swap or a valuation dispute resolution process;

• Reduced recordkeeping requirements under § 23.504(b)(6);

• Removed the 5 percent annual documentation audit requirement in favor of a more general audit standard; and

• Modified the swap valuation dispute reporting requirement to reduce the number of disputes that must be reported to the Commission, the SEC, and any applicable prudential regulator, and replaced the one-day reporting requirement with a three-day requirement for SDs and MSPs.

The Commission believes that these changes will reduce or eliminate many of the burden concerns raised by commenters.

Still, the Commission anticipates that significant costs will be incurred as a result of these documentation rules. Although the rules do not apply retroactively—that is, concerns regarding the need to re-negotiate already agreed-upon contracts are null—there will be costs going forward for market participants. Registrants will have to (i) Negotiate and document all terms of each trading relationship; (ii) design, compose, and implement policies and procedures reasonably designed to ensure the execution of swap trading relationship documentation, including valuation documentation; (iii) obtain documentation from counterparties who are claiming the end user exception to clearing; (iv) periodically audit documentation; and (v) keep records and/or make reports as required under §§ 23.504(d)–(e) and 23.505(b).

In its Documentation NPRM, the Commission considered the costs of its proposal and noted that memorializing the specific terms of the swap trading relationship and swap transactions between counterparties is prudent business practice and, in fact, many market participants already use standardized documentation. Accordingly, it is believed that many, if not most, SDs and MSPs currently execute and maintain trading relationship documentation of the type required by proposed § 23.504 in the ordinary course of their businesses, including documentation that contains several of the terms that would be required by the proposed rules. Thus, the hour and dollar burdens associated with the swap trading relationship documentation requirements may be limited to amending existing documentation to expressly include any additional terms required by the proposed rules.

The Commission also explained its belief that, to the extent any substantial amendments or additions to existing documentation would be needed, such revisions would likely apply to multiple counterparties, thereby reducing the per counterparty burden imposed upon SDs and MSPs. In addition, in its proposal, the Commission anticipated that standardized swap trading relationship documentation will develop quickly and progressively within the industry, dramatically reducing the cost to individual participants.

Indeed, the Commission is aware of industry-led efforts already underway to bring trading relationship documentation into compliance with new Dodd-Frank Act requirements.[135] These types of initiatives are likely to lower overall costs to market participants.

The Commission further expects the per hour and dollar burdens to be incurred predominantly in the first year or two after the effective date of the final regulations. Once an SD or MSP has changed its pre-existing documentation with each of its counterparties to comply with the proposed rules, there likely will be little need to further modify such documentation on an ongoing basis.

In terms of quantification, the Commission recognizes IECA's comments indicating that the primary costs of the documentation and valuation rules will be legal costs. In terms of a per hour fee, the Commission has previously cited Bureau of Labor Statistics findings that the mean hourly wage of an employee under occupation code 23–1011, ''Lawyers,'' that is employed by the ''Securities and Commodity Contracts Intermediation and Brokerage Industry'' is $82.22.[136] The Commission has adjusted this amount upward to $100 per hour because SDs and MSPs include large financial institutions whose employees' salaries may exceed the mean wage provided. To account for the possibility that the services of outside counsel may be required to satisfy the requirements associated with negotiating, drafting, and maintaining the required trading relationship documentation, the Commission used an average salary of $125 per hour. In response to comments that the hourly rate should be increased further, the Commission notes that any determination to use outside counsel is at the discretion of the registrant. Accordingly, the per-hour estimate for legal costs associated with these rules is $125–500 per hour. In terms of the number of hours required to amend documentation, whether the requirement be ten hours or substantially more, the Commission notes that industry-wide efforts could reduce this amount significantly.

The Commission also notes the NERA report regarding the costs of an annual audit. Given the alternative audit requirement finalized in these rules, the Commission expects that the audit costs would be reduced, perhaps significantly.

In conclusion, the Commission believes the final rules for documentation of swap trading relationships are appropriate to ensure the efficient and orderly operation of bilateral derivatives markets and to

Working Group of Commercial Energy Firms, December 20, 2011. In the late-filed comment supplement, NERA estimates these costs for entities ''engaged in production, physical distribution or marketing of natural gas, power, or oil that also engage in active trading of energy derivatives''—termed ''nonfinancial energy companies'' in the report. The figure cited includes costs to maintain a risk management program, quarterly audits of the program, and annual audits of swap trading relationship documentation, the first two of which are required under a separate rulemaking previously adopted by the Commission.

[135] ISDA is partnering with Markit to launch a technology-based solution enabling counterparties to amend their OTC derivatives documentation quickly and efficiently to comply with Dodd-Frank regulatory requirements. *See http://www2.isda.org/dodd-frank-documentation-initiative/.*

[136] *http.www.bls.gov/oes/2099/mayowe23.1011.htm.*

reduce the legal, operational, counterparty credit, and market risk that can arise from undocumented terms. The final rules promote an appropriate level of standardization; while the Commission does not believe the rules prohibit customized terms, the manner in which they are documented (i.e. written, pre-arranged terms that must include certain types of agreements as applicable) will become standardized. SDs, MSPs, and their counterparties alike will have certainty regarding what their documentation must include, though the actual terms are still readily negotiable. The Commission agrees with the Financial Stability Oversight Board OTC Derivatives Working Group that increased documentation standardization should improve the market in a number of ways, including (i) Facilitating automated processing of transactions; (ii) increasing the fungibility of contracts, which enables greater market liquidity; (iii) improving valuation and risk management; (iv) increasing the reliability of price information; (v) reducing the number of problems in matching trades; and (vi) facilitating reporting to SDRs.

J. Section 15(a) Considerations: Swap Trading Relationship Documentation

1. Protection of Market Participants and the Public

The final documentation rules will protect market participants by ensuring that every trading relationship and every transaction is properly documented. Full and transparent documentation diminishes the risk of unfair practices like valuing a swap to advantage one party at the expense of the other. As such, documentation protects particularly those parties most susceptible to being taken advantage of, such as non-financial entities. In addition, the legal and credit certainty provided by proper documentation provides protection to both sides of a relationship by ensuring a clear understanding of options and obligations, particularly in case of dispute or market crisis.

The provisions in the final rules related to valuation also provide protection to market participants from costly disputes over the collateralization of a swap; such disputes exacerbated the financial crisis as proper collateralization for risk management purposes could not be determined.

2. Efficiency, Competitiveness, and Financial Integrity of Derivatives Markets

As proper documentation encourages orderly operations and diminishes risk, the Commission believes the final rules improve the efficiency of markets. Increased standardization should allow for increased competition among SDs and MSPs, whose counterparties will be better able to compare between swap trading relationships to determine which relationships with which dealers best suit their needs. The transparency and certainty provided by proper documentation, in addition to the diminished risk of predatory trading practices, should improve the integrity of bilateral derivatives markets. Overall, then, the Commission considers the final rules to have a net positive impact on the efficiency, competitiveness, and financial integrity of derivatives markets.

3. Price Discovery

To the extent the final rules improve the process of valuing swap transactions between counterparties, they should also increase the reliability of pricing information; this increase in pricing reliability should improve the price discovery function of bilateral markets.

4. Sound Risk Management

Proper documentation of trading relationships and transactions is essential to sound risk management; simply put, if a dealer is unaware or unsure of agreed-upon terms and policies, it cannot be managing risk as efficiently as possible. The final rules, because they require full documentation of all facets of the relationship between counterparties, mitigate (i) The legal risk inherent in poorly documented or oral contracts; (ii) the counterparty credit risk that stems from improper documentation of credit terms and the counterparty credit risk that could occur based on false or misleading representations by either counterparty; and (iii) the operational risk that arises when internal operations personnel and systems do not have full or identical information regarding a particular transaction or counterparty.

The final valuation rules also provide support for sound risk management practices because they strive to ensure that two counterparties are not disputing the value of a transaction where margin or other cash flows are being exchanged. Limiting the risk that unresolved disputes can create in the marketplace as a whole—again considering the role valuation disputes played in the 2008 financial crisis—should allow systemic risk management as well as improving the risk management processes of individual market participants.

5. Other Public Interest Considerations

The Commission has not identified other public interest considerations as a result of these rules.

V. Related Matters

A. Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA) [137] requires that agencies consider whether the rules they propose will have a significant economic impact on a substantial number of small entities and, if so, provide a regulatory flexibility analysis respecting the impact. The Commission has already established certain definitions of ‘‘small entities’’ to be used in evaluating the impact of its rules on such small entities in accordance with the RFA.[138] SDs and MSPs are new categories of registrant. Accordingly, the Commission noted in the proposals that it had not previously addressed the question of whether such persons were, in fact, small entities for purposes of the RFA.

In this regard, the Commission explained that it previously had determined that FCMs should not be considered to be small entities for purposes of the RFA, based, in part, upon FCMs' obligation to meet the minimum financial requirements established by the Commission to enhance the protection of customers' segregated funds and protect the financial condition of FCMs generally. Like FCMs, SDs will be subject to minimum capital and margin requirements, and are expected to comprise the largest global financial firms—and the Commission is required to exempt from designation as an SD entities that engage in a de minimis level of swaps dealing in connection with transactions with or on behalf of customers. Accordingly, for purposes of the RFA for the proposals and future rulemakings, the Commission proposed that SDs not be considered ‘‘small entities’’ for essentially the same reasons that it had previously determined FCMs not to be small entities.

The Commission further explained that it had also previously determined that large traders are not ‘‘small entities’’ for RFA purposes, with the Commission considering the size of a trader's position to be the only appropriate test for the purpose of large trader reporting. The Commission then noted that MSPs maintain substantial positions in swaps, creating substantial counterparty exposure that could have serious adverse effects on the financial

[137] 5 U.S.C. 601 *et seq.*

[138] 47 FR 18618 (Apr. 30, 1982).

stability of the United States banking system or financial markets. Accordingly, for purposes of the RFA for the proposals and future rulemakings, the Commission proposed that MSPs not be considered ''small entities'' for essentially the same reasons that it previously had determined large traders not to be small entities.

The Commission concluded its RFA analysis applicable to SDs and MSPs as follows: ''The Commission is carrying out Congressional mandates by proposing these rules. The Commission is incorporating registration of SDs and MSPs into the existing registration structure applicable to other registrants. In so doing, the Commission has attempted to accomplish registration of SDs and MSPs in the manner that is least disruptive to ongoing business and most efficient and expeditious, consistent with the public interest, and accordingly believes that these registration rules will not present a significant economic burden on any entity subject thereto.''

The Commission did not receive any comments on its analysis of the application of the RFA to SDs and MSPs. Moreover, during the time period since the rule proposals were published in the **Federal Register**, the Commission has issued final rules in which it determined that the registration and regulation of SDs and MSPs would not have a significant economic impact on a substantial number of small entities.[139] Accordingly, pursuant to Section 605(b) of the RFA, 5 U.S.C. 605(b), the Chairman, on behalf of the Commission, certifies that these rules will not have a significant economic impact on a substantial number of small entities.

B. Paperwork Reduction Act

The Commission may not conduct or sponsor, and a registrant is not required to respond to, a collection of information unless it displays a currently valid Office of Management and Budget (OMB) control number. The Commission's adoption of §§ 23.500 through 23.505 (Swap Confirmation, Portfolio Reconciliation, Portfolio Compression, Swap Trading Relationship Documentation, and End User Exception Documentation) imposes new information collection requirements on registrants within the meaning of the Paperwork Reduction Act.[140]

Accordingly, the Commission requested and OMB assigned control numbers for the required collections of information. The Commission has submitted this notice of final rulemaking along with supporting documentation for OMB's review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The title for these collections of information are ''Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, OMB control number 3038–0088,'' ''Confirmation, Portfolio Reconciliation, and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants, OMB control number 3038–0068,'' and ''Orderly Liquidation Termination Provision in Swap Trading Relationship Documentation for Swap Dealers and Major Swap Participants, OMB control number 3038–0083.'' [141] Many of the responses to this new collection of information are mandatory.

The Commission protects proprietary information according to the Freedom of Information Act and 17 CFR part 145, ''Commission Records and Information.'' In addition, Section 8(a)(1) of the CEA strictly prohibits the Commission, unless specifically authorized by the Act, from making public ''data and information that would separately disclose the business transactions or market positions of any person and trade secrets or names of customers.'' The Commission also is required to protect certain information contained in a government system of records according to the Privacy Act of 1974, 5 U.S.C. 552a.

The regulations require each respondent to furnish certain information to the Commission and to maintain certain records. The Commission invited the public and other Federal agencies to comment on any aspect of the information collection requirements discussed in the Documentation NPRM, the Confirmation NPRM, and the Orderly Liquidation NPRM. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicited comments in order to: (i) Evaluate whether the proposed collections of information were necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility; (ii) evaluate the accuracy of the Commission's estimates of the burden of the proposed collections of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

It is not currently known how many SDs and MSPs will become subject to these rules, and this will not be known to the Commission until the registration requirements for these entities become effective. In its rule proposals, the Commission took ''a conservative approach'' to calculating the burden hours of this information collection by estimating that as many as 300 SDs and MSPs would register.[142] Since publication of the proposals in late 2010 and early 2011, the Commission has met with industry participants and trade groups, discussed extensively the universe of potential registrants with NFA, and reviewed public information about SDs active in the market and certain trade groups. Over time, and as the Commission has gathered more information on the swaps market and its participants, the estimate of the number of SDs and MSPs has decreased. In its FY 2012 budget drafted in February 2011, the Commission estimated that 140 SDs might register with the Commission.[143] After recently receiving additional specific information from NFA on the regulatory program it is developing for SDs and MSPs,[144] however, the Commission believes that approximately 125 SDs and MSPs, including only a handful of MSPs, will register. While the Commission originally estimated there might be approximately 300 SDs and MSPs, based on new estimates provided by NFA, the Commission now estimates

[139] *See, e.g.,* Registration of Swap Dealers and Major Swap Participants, 77 FR 2613 (Jan. 19, 2012); Swap Dealer and Major Swap Participant Recordkeeping, Reporting, and Duties Rules; Futures Commission Merchant and Introducing Broker Conflicts of Interest Rules; and Chief Compliance Officer Rules for Swap Dealers, Major Swap Participants, and Futures Commission Merchants, 77 FR 20128 (Apr. 3, 2012).

[140] 44 U.S.C. 3501 *et seq.*

[141] These collections include certain collections required under the Business Conduct Standards with Counterparties rulemaking, as stated in that rulemaking. *See* Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 FR 9734 (Feb. 17, 2012).

[142] See 75 FR at 81528; 76 FR at 6713; 76 FR at 6723.

[143] CFTC, President's Budget and Performance Plan Fiscal Year 2010, p. 13–14 (Feb. 2011), *available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/cftcbudget2012.pdf.* The estimated 140 SDs includes ''[a]pproximately 80 global and regional banks currently known to offer swaps in the United States;'' ''[a]pproximately 40 non-bank swap dealers currently offering commodity and other swaps;'' and ''[a]pproximately 20 new potential market makers that wish to become swap dealers.'' *Id.*

[144] Letter from Thomas W. Sexton, Senior Vice President and General Counsel, NFA to Gary Barnett, Director, Division of Swap Dealer and Intermediary Oversight, CFTC (Oct. 20, 2011) (NFA Cost Estimates Letter).

that there will be a combined number of 125 SDs and MSPs that will be subject to new information collection requirements under these rules.[145]

For purposes of the PRA, the term ''burden'' means the ''time, effort, or financial resources expended by persons to generate, maintain, or provide information to or for a Federal Agency.''

For most of the provisions set forth in the NPRMs, the Commission estimated the cost burden of the proposed regulations based upon an average salary for Financial Managers of $100 per hour. In addition, for certain provisions in the Documentation NPRM, the Commission estimated the cost burden of the proposed regulations based upon an average salary for Lawyers of $125 per hour. In response to these estimates, The Working Group commented that, inclusive of benefit costs and allocated overhead, the per-hour average salary estimate for compliance and risk management personnel should be significantly higher than $120. FIA and SIFMA stated that some of the compliance policies required by the proposed regulations will be drafted by both in-house lawyers and outside counsel, so the blended hourly rate should be roughly $400.

The Commission notes that its wage estimates were based on recent Bureau of Labor Statistics findings, including the mean hourly wage of an employee under occupation code 23–1011, ''Lawyers,'' that is employed by the ''Securities and Commodity Contracts Intermediation and Brokerage Industry,'' which is $82.22. The mean hourly wage of an employee under occupation code 11–3031, ''Financial Managers,'' (which includes operations managers) in the same industry is $74.41.[146] Taking these data, the Commission then increased its hourly wage estimates in recognition of the fact that some registrants may be large financial institutions whose employees' salaries may exceed the mean wage. The Commission also observes that SIFMA's ''Report on Management & Professional Earnings in the Securities Industry—2010'' estimates the average wage of a compliance attorney and a compliance staffer in the U.S. at only $46.31 per hour.

The Commission recognizes that some registrants may hire outside counsel with expertise in the various regulatory areas covered by the regulations discussed herein. While the Commission is uncertain about the billing rates that registrants may pay for outside counsel, the Commission believes that such counsel may bill at a rate of several hundred dollars per hour. Outside counsel may be able to leverage its expertise to reduce substantially the number of hours needed to fulfill a requested assignment, but a registrant that uses outside counsel may incur higher costs than a registrant that does not use outside counsel. Any determination to use outside counsel is at the discretion of the registrant. Having considered the comments received and having reviewed the available data, the Commission has determined that $100 per hour for Financial Managers, and $125 for Lawyers, remain reasonable estimates of the per-hour average salary for purposes of its PRA analysis. The Commission also notes that this determination is consistent with the Commission's estimate for the hourly wage for CCOs under the recently adopted final rules establishing certain internal business conduct standards for SDs and MSPs.[147]

The Commission received comments related to the PRA in response to its notices of proposed rulemaking. Notably, none of these commenters suggested specific revised calculations with regard to the Commission's burden estimate.

IECA commented that if all confirmations must be in writing, the additional employee time cost for each market participant would be substantial and is not included in the annual cost analysis. IECA also commented that the estimate of 10 hours per counterparty to negotiate new documentation is too low. Because the rule requires transaction-by-transaction valuation methodologies that will need to be newly negotiated for many transactions, IECA believes the Commission should calculate an aggregate amount based on the number of transactions. Also, the time needed must include not only negotiation, but also time for determining pricing points and inputs, executive decision-maker time, and also senior management and board time for reviewing forms and material modifications. Time will also be needed to reevaluate the ISDA documentation if the Commission does not state that such are acceptable.

The Working Group requested that the Commission evaluate the proposed rules in light of its various recordkeeping and reporting proposals, as such may cause firms to incur tremendous administrative obligations to record changes to its swap portfolio, its accounting records, treasury arrangements and capital allocations (including loss of cash flow hedging treatment under hedge accounting rules), as well as incurring reporting obligations to swap data repositories on a swap-by-swap basis.

The Commission has considered the comments received concerning the PRA-related burden estimates set forth in the notices of proposed rulemaking. However, because none of the commenters suggested specific revised calculations on the estimates, the only change that the Commission is making to its estimation of annual burdens associated with the rules is the change to reflect the new estimate of the number of SDs and MSPs.

With respect to the rules proposed in the Documentation NPRM, the Commission now estimates the initial burden to be 6,168 hours per year, at an initial annual cost of $684,300, for each SD and MSP, and the initial aggregate burden cost for all registrants is $85,537,500.[148] With respect to the rules proposed in the Confirmation NPRM, the Commission now estimates the burden to be 1,282.5 hours, at an annual cost of $128,250 for each SD and MSP, and the aggregate burden cost for all registrants is 160,312.5 burden hours and $16,031,250. With respect to the rules set forth in the Orderly Liquidation NPRM, the Commission now estimates the initial burden to be 270 hours per year, at an initial annual cost of $27,000 for each SD and MSP, and the initial aggregate burden cost for all registrants is 33,750 burden hours and $3,375,000.[149]

In total, the Commission estimates that the rules set forth in this Adopting Release will impose a burden of 7,720.5 hours per year, at an initial annual cost of $839,550, for each SD and MSP, and

[145] NFA Letter (Oct. 20, 2011) (estimating that there will be 125 SDs and MSPs required to register with NFA).

[146] *See http://www.bls.gov/oes/2099/mayowe23.1011.htm* and *http://www.bls.gov/oes/current/oes113031.htm.*

[147] *See* Swap Dealer and Major Swap Participant Recordkeeping, Reporting, and Duties Rules; Futures Commission Merchant and Introducing Broker Conflicts of Interest Rules; and Chief Compliance Officer Rules for Swap Dealers, Major Swap Participants, and Futures Commission Merchants, 77 FR 20128, 20196 (Apr. 3, 2012).

[148] As noted in the Documentation NPRM, the Commission has characterized the annual costs as initial annual costs, since the Commission anticipates that the cost burdens will be reduced dramatically over time as the agreements and other records required by the proposed regulations become increasingly standardized within the industry. 76 FR at 6722.

[149] *See id.* (discussing the characterization of the annual costs as initial annual costs). The Commission notes that the substantive requirements under the Orderly Liquidation rule have been reduced significantly. While the proposal required the parties to negotiate and agree on documentation provisions, the final rules requires only a simple notice. The Commission has elected not to alter its PRA burden estimate, but observes that such estimates are likely to overstate the actual burden significantly.

the aggregate burden cost for all registrants is $104,943,750.

In addition to the burden hours discussed above, the Commission anticipates that SDs and MSPs may incur certain start-up costs in connection with the proposed recordkeeping obligations. Such costs would include the expenditures related to developing and installing new technology and systems, or reprogramming or updating existing recordkeeping technology and systems, to enable the SD or MSP to collect, capture, process, maintain, and re-produce any newly required records. The Commission received no comments with respect to the estimated number of burden hours for these start-up costs, or with respect to the programming wage estimate of $60 per hour. Accordingly, the Commission estimates that the start-up costs would require 40 burden hours for the rules proposed in the Documentation NPRM and 40 hours for the rules proposed in the Confirmation NPRM.[150] Thus, the estimated start-up burden associated with the required technological improvements would be $4,800 [$60 × 80 hours per affected registrant] or $600,000 in the aggregate.[151]

List of Subjects in 17 CFR Part 23

Antitrust, Commodity futures, Conduct standards, Conflict of Interests, Major swap participants, Reporting and recordkeeping, Swap dealers, Swaps.

For the reasons stated in this release, the Commission amends 17 CFR part 23 as follows:

PART 23—SWAP DEALERS AND MAJOR SWAP PARTICIPANTS

■ 1. The authority citation for part 23 continues 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.

■ 2. Subpart I (consisting of §§ 23.500, 23.501, 23.502, 23.503, 23.504, and 23.505) is added to read as follows:

[150] The Commission does not anticipate that SDs and MSPs will incur any start-up costs in connection with the proposed recordkeeping obligations in the rules proposed in the Orderly Liquidation NPRM, other than those previously noted and accounted for in the Documentation NPRM and Confirmation NPRM.

[151] According to recent Bureau of Labor Statistics findings, 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. *See http://www.bls.gov/oes/current/oes113031.htm.* Because SDs and MSPs 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.

Subpart I—Swap Documentation

Sec.

Subpart I—Swap Documentation

§ 23.500 Definitions.

For purposes of this subpart I, the following terms shall be defined as provided.

(a) *Acknowledgment* means a written or electronic record of all of the terms of a swap signed and sent by one counterparty to the other.

(b) *Bilateral portfolio compression exercise* means an exercise in which two swap counterparties wholly terminate or change the notional value of some or all of the swaps submitted by the counterparties for inclusion in the portfolio compression exercise and, depending on the methodology employed, replace the terminated swaps with other swaps whose combined notional value (or some other measure of risk) is less than the combined notional value (or some other measure of risk) of the terminated swaps in the exercise.

(c) *Confirmation* means the consummation (electronically or otherwise) of legally binding documentation (electronic or otherwise) that memorializes the agreement of the counterparties to all of the terms of a swap transaction. A confirmation must be in writing (whether electronic or otherwise) and must legally supersede any previous agreement (electronically or otherwise). A confirmation is created when an acknowledgment is manually, electronically, or by some other legally equivalent means, signed by the receiving counterparty.

(d) *Execution* means, with respect to a swap transaction, an agreement by the counterparties (whether orally, in writing, electronically, or otherwise) to the terms of the swap transaction that legally binds the counterparties to such terms under applicable law.

(e) *Financial entity* means a counterparty that is not a swap dealer or a major swap participant and that is one of the following:

(1) A commodity pool as defined in Section 1a(5) of the Act;

(2) A private fund as defined in Section 202(a) of the Investment Advisors Act of 1940;

(3) An employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income and Security Act of 1974;

(4) A person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature as defined in Section 4(k) of the Bank Holding Company Act of 1956; and

(5) A security-based swap dealer or a major security-based swap participant.

(f) *Fully offsetting swaps* means swaps of equivalent terms where no net cash flow would be owed to either counterparty after the offset of payment obligations thereunder.

(g) *Material terms* means all terms of a swap required to be reported in accordance with part 45 of this chapter.

(h) *Multilateral portfolio compression exercise* means an exercise in which multiple swap counterparties wholly terminate or change the notional value of some or all of the swaps submitted by the counterparties for inclusion in the portfolio compression exercise and, depending on the methodology employed, replace the terminated swaps with other swaps whose combined notional value (or some other measure of risk) is less than the combined notional value (or some other measure of risk) of the terminated swaps in the compression exercise.

(i) *Portfolio reconciliation* means any process by which the two parties to one or more swaps:

(1) Exchange the terms of all swaps in the swap portfolio between the counterparties;

(2) Exchange each counterparty's valuation of each swap in the swap portfolio between the counterparties as of the close of business on the immediately preceding business day; and

(3) Resolve any discrepancy in material terms and valuations.

(j) *Prudential regulator* has the meaning given to the term in section 1a(39) of the Commodity Exchange Act and includes the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Association, and the Federal Housing Finance Agency, as applicable to the swap dealer or major swap participant.

(k) *Swap portfolio* means all swaps currently in effect between a particular swap dealer or major swap participant and a particular counterparty.

(l) *Swap transaction* means any event that results in a new swap or in a change to the terms of a swap, including execution, termination, assignment, novation, exchange, transfer, amendment, conveyance, or extinguishing of rights or obligations of a swap.

(m) *Valuation* means the current market value or net present value of a swap.

§ 23.501 Swap confirmation.

(a) *Confirmation.* Subject to the compliance schedule in paragraph (c) of this section:

(1) Each swap dealer and major swap participant entering into a swap transaction with a counterparty that is a swap dealer or major swap participant shall execute a confirmation for the swap transaction as soon as technologically practicable, but in any event by the end of first business day following the day of execution.

(2) Each swap dealer and major swap participant entering into a swap transaction with a counterparty that is not a swap dealer or a major swap participant shall send an acknowledgment of such swap transaction as soon as technologically practicable, but in any event by the end of the first business day following the day of execution.

(3) (i) Each swap dealer and major swap participant shall establish, maintain, and follow written policies and procedures reasonably designed to ensure that it executes a confirmation for each swap transaction that it enters into with a counterparty that is a financial entity as soon as technologically practicable, but in any event by the end of the first business day following the day of execution.

(ii) Each swap dealer and major swap participant shall establish, maintain, and follow written policies and procedures reasonably designed to ensure that it executes a confirmation for each swap transaction that it enters into with a counterparty that is not a swap dealer, major swap participant, or a financial entity not later than the end of the second business day following the day of execution.

(iii) Such procedures shall include a requirement that, upon a request by a prospective counterparty prior to execution of any such swap, the swap dealer or major swap participant furnish to the prospective counterparty prior to execution a draft acknowledgment specifying all terms of the swap transaction other than the applicable pricing and other relevant terms that are to be expressly agreed at execution.

(4) Swaps executed on a swap execution facility, designated contract market, or submitted for clearing by a derivatives clearing organization.

(i) Any swap transaction executed on a swap execution facility or designated contract market shall be deemed to satisfy the requirements of this section, provided that the rules of the swap execution facility or designated contract market establish that confirmation of all terms of the transaction shall take place at the same time as execution.

(ii) Any swap transaction submitted for clearing by a derivatives clearing organization shall be deemed to satisfy the requirements of this section, provided that:

(A) The swap transaction is submitted for clearing as soon as technologically practicable, but in any event no later than the times established for confirmation under paragraphs (a)(1) or (3) of this section, and

(B) Confirmation of all terms of the transaction takes place at the same time as the swap transaction is accepted for clearing pursuant to the rules of the derivatives clearing organization.

(iii) If a swap dealer or major swap participant receives notice that a swap transaction has not been confirmed by a swap execution facility or a designated contract market, or accepted for clearing by a derivatives clearing organization, the swap dealer or major swap participant shall execute a confirmation for such swap transaction as soon as technologically practicable, but in any event no later than the times established for confirmation under paragraphs (a)(1) or (3) of this section as if such swap transaction were executed at the time the swap dealer or major swap participant receives such notice.

(5) For purposes of this section:

(i) ''Day of execution'' means the calendar day of the party to the swap transaction that ends latest, provided that if a swap transaction is—

(A) Entered into after 4:00 p.m. in the place of a party; or

(B) Entered into on a day that is not a business day in the place of a party, then such swap transaction shall be deemed to have been entered into by that party on the immediately succeeding business day of that party, and the day of execution shall be determined with reference to such business day; and

(ii) ''Business day'' means any day other than a Saturday, Sunday, or legal holiday.

(b) *Recordkeeping.* (1) Each swap dealer and major swap participant shall make and retain a record of:

(i) The date and time of transmission to, or receipt from, a counterparty of any acknowledgment; and

(ii) The date and time of transmission to, or receipt from, a counterparty of any confirmation.

(2) All records required to be maintained pursuant to this section shall be maintained in accordance with § 23.203 and shall be made available promptly upon request to any representative of the Commission or any applicable prudential regulator, or with regard to swaps defined in section 1a(47)(A)(v), to any representative of the Commission, the Securities and Exchange Commission, or any applicable prudential regulator.

(c) *Compliance schedule.* The requirements of paragraph (a) of this section are subject to the following compliance schedule:

(1) For purposes of paragraph (a)(1) of this section, each swap dealer and major swap participant entering into a swap transaction that is or involves a credit swap or interest rate swap with a counterparty that is a swap dealer or major swap participant shall execute a confirmation for the swap transaction as soon as technologically practicable, but in any event by:

(i) The end of the second business day following the day of execution for the period from the effective date of this section to February 28, 2014; and

(ii) The end of the first business day following the day of execution from and after March 1, 2014.

(2) For purposes of paragraph (a)(1) of this section, each swap dealer and major swap participant entering into a swap transaction that is or involves an equity swap, foreign exchange swap, or other commodity swap with a counterparty that is a swap dealer or major swap participant shall execute a confirmation for the swap transaction as soon as technologically practicable, but in any event by:

(i) The end of the third business day following the day of execution for the period from the effective date of this section to August 31, 2013;

(ii) The end of the second business day following the day of execution for the period from September 1, 2013 to August 31, 2014; and

(iii) The end of the first business day following the day of execution from and after September 1, 2014.

(3) For purposes of paragraph (a)(2) of this section, each swap dealer and major swap participant entering into a swap transaction that is or involves a credit swap or interest rate swap with a counterparty that is not a swap dealer or a major swap participant shall send an acknowledgment of such swap transaction as soon as technologically practicable, but in any event by:

(i) The end of the second business day following the day of execution for the period from the effective date of this section to February 28, 2014; and

(ii) The end of the first business day following the day of execution from and after March 1, 2014.

(4) For purposes of paragraph (a)(2) of this section, each swap dealer and major

swap participant entering into a swap transaction that is or involves an equity swap, foreign exchange swap, or other commodity swap with a counterparty that is not a swap dealer or a major swap participant shall send an acknowledgment of such swap transaction as soon as technologically practicable, but in any event by:

(i) The end of the third business day following the day of execution for the period from the effective date of this section to August 31, 2013;

(ii) The end of the second business day following the day of execution for the period from September 1, 2013 to August 31, 2014; and

(iii) The end of the first business day following the day of execution from and after September 1, 2014.

(5) For purposes of paragraph (a)(3)(i) of this section, each swap dealer and major swap participant shall establish, maintain, and follow written policies and procedures reasonably designed to ensure that it executes a confirmation for each swap transaction that is or involves a credit swap or interest rate swap that it enters into with a counterparty that is a financial entity as soon as technologically practicable, but in any event by:

(i) The end of the second business day following the day of execution for the period from the effective date of this section to February 28, 2014; and

(ii) The end of the first business day following the day of execution from and after March 1, 2014.

(6) For purposes of paragraph (a)(3)(i) of this section, each swap dealer and major swap participant shall establish, maintain, and follow written policies and procedures reasonably designed to ensure that it executes a confirmation for each swap transaction that is or involves an equity swap, foreign exchange swap, or other commodity swap that it enters into with a counterparty that is a financial entity as soon as technologically practicable, but in any event by:

(i) The end of the third business day following the day of execution for the period from the effective date of this section to August 31, 2013;

(ii) The end of the second business day following the day of execution for the period from September 1, 2013 to August 31, 2014; and

(iii) The end of the first business day following the day of execution from and after September 1, 2014.

(7) For purposes of paragraph (a)(3)(ii) of this section, each swap dealer and major swap participant shall establish, maintain, and follow written policies and procedures reasonably designed to ensure that it executes a confirmation for each swap transaction that is or involves a credit swap or interest rate swap that it enters into with a counterparty that is not a swap dealer, major swap participant, or a financial entity not later than:

(i) The end of the fifth business day following the day of execution for the period from the effective date of this section to August 31, 2013;

(ii) The end of the third business day following the day of execution for the period from September 1, 2013 to August 31, 2014; and

(iii) The end of the second business day following the day of execution from and after September 1, 2014.

(8) For purposes of paragraph (a)(3)(ii) of this section, each swap dealer and major swap participant shall establish, maintain, and follow written policies and procedures reasonably designed to ensure that it executes a confirmation for each swap transaction that is or involves an equity swap, foreign exchange swap, or other commodity swap that it enters into with a counterparty that is not a swap dealer, major swap participant, or a financial entity not later than:

(i) The end of the seventh business day following the day of execution for the period from the effective date of this section to August 31, 2013;

(ii) The end of the fourth business day following the day of execution for the period from September 1, 2013 to August 31, 2014; and

(iii) The end of the second business following the day of execution from and after September 1, 2014.

(9) For purposes of paragraph (c) of this section:

(i) ''Credit swap'' means any swap that is primarily based on instruments of indebtedness, including, without limitation: Any swap primarily based on one or more broad-based indices related to instruments of indebtedness; and any swap that is an index credit swap or total return swap on one or more indices of debt instruments;

(ii) ''Equity swap'' means any swap that is primarily based on equity securities, including, without limitation: Any swap primarily based on one or more broad-based indices of equity securities; and any total return swap on one or more equity indices;

(iii) ''Foreign exchange swap'' has the meaning set forth in section 1a(25) of the CEA. It does not include swaps primarily based on rates of exchange between different currencies, changes in such rates, or other aspects of such rates (sometimes known as ''cross-currency swaps'');

(iv) ''Interest rate swap'' means any swap which is primarily based on one or more interest rates, such as swaps of payments determined by fixed and floating interest rates; or any swap which is primarily based on rates of exchange between different currencies, changes in such rates, or other aspects of such rates (sometimes known as ''cross-currency swaps''); and

(v) ''Other commodity swap'' means any swap not included in the credit, equity, foreign exchange, or interest rate asset classes, including, without limitation, any swap for which the primary underlying item is a physical commodity or the price or any other aspect of a physical commodity.

§ 23.502 Portfolio reconciliation.

(a) *Swaps with swap dealers or major swap participants.* Each swap dealer and major swap participant shall engage in portfolio reconciliation as follows for all swaps in which its counterparty is also a swap dealer or major swap participant.

(1) Each swap dealer or major swap participant shall agree in writing with each of its counterparties on the terms of the portfolio reconciliation.

(2) The portfolio reconciliation may be performed on a bilateral basis by the counterparties or by a qualified third party.

(3) The portfolio reconciliation shall be performed no less frequently than:

(i) Once each business day for each swap portfolio that includes 500 or more swaps;

(ii) Once each week for each swap portfolio that includes more than 50 but fewer than 500 swaps on any business day during any week; and

(iii) Once each calendar quarter for each swap portfolio that includes no more than 50 swaps at any time during the calendar quarter.

(4) Each swap dealer and major swap participant shall resolve immediately any discrepancy in a material term of a swap identified as part of a portfolio reconciliation or otherwise.

(5) Each swap dealer and major swap participant shall establish, maintain, and follow written policies and procedures reasonably designed to resolve any discrepancy in a valuation identified as part of a portfolio reconciliation or otherwise as soon as possible, but in any event within five business days, provided that the swap dealer and major swap participant establishes, maintains, and follows written policies and procedures reasonably designed to identify how the swap dealer or major swap participant will comply with any variation margin requirements under section 4s(e) of the Act and regulations under this part pending resolution of the discrepancy in

valuation. A difference between the lower valuation and the higher valuation of less than 10 percent of the higher valuation need not be deemed a discrepancy.

(b) *Swaps with entities other than swap dealers or major swap participants.* Each swap dealer and major swap participant shall establish, maintain, and follow written policies and procedures reasonably designed to ensure that it engages in portfolio reconciliation as follows for all swaps in which its counterparty is neither a swap dealer nor a major swap participant.

(1) Each swap dealer or major swap participant shall agree in writing with each of its counterparties on the terms of the portfolio reconciliation, including agreement on the selection of any third-party service provider.

(2) The portfolio reconciliation may be performed on a bilateral basis by the counterparties or by one or more third parties selected by the counterparties in accordance with paragraph (b)(1) of this section.

(3) The required policies and procedures shall provide that portfolio reconciliation will be performed no less frequently than:

(i) Once each calendar quarter for each swap portfolio that includes more than 100 swaps at any time during the calendar quarter; and

(ii) Once annually for each swap portfolio that includes no more than 100 swaps at any time during the calendar year.

(4) Each swap dealer or major swap participant shall establish, maintain, and follow written procedures reasonably designed to resolve any discrepancies in the material terms or valuation of each swap identified as part of a portfolio reconciliation or otherwise with a counterparty that is neither a swap dealer nor major swap participant in a timely fashion. A difference between the lower valuation and the higher valuation of less than 10 percent of the higher valuation need not be deemed a discrepancy.

(c) *Reporting.* Each swap dealer and major swap participant shall promptly notify the Commission and any applicable prudential regulator, or with regard to swaps defined in section 1a(47)(A)(v) of the Act, the Commission, the Securities and Exchange Commission, and any applicable prudential regulator, of any swap valuation dispute in excess of $20,000,000 (or its equivalent in any other currency) if not resolved within:

(1) Three (3) business days, if the dispute is with a counterparty that is a swap dealer or major swap participant; or

(2) Five (5) business days, if the dispute is with a counterparty that is not a swap dealer or major swap participant.

(d) *Reconciliation of cleared swaps.* Nothing in this section shall apply to a swap that is cleared by a derivatives clearing organization.

(e) *Recordkeeping.* A record of each swap portfolio reconciliation consistent with § 23.202(a)(3)(iii) shall be maintained in accordance with § 23.203.

§ 23.503 Portfolio compression.

(a) *Portfolio compression with swap dealers and major swap participants.*

(1) *Bilateral offset.* Each swap dealer and major swap participant shall establish, maintain, and follow written policies and procedures for terminating each fully offsetting swap between a swap dealer or major swap participant and another swap dealer or major swap participant in a timely fashion, when appropriate.

(2) *Bilateral compression.* Each swap dealer and major swap participant shall establish, maintain, and follow written policies and procedures for periodically engaging in bilateral portfolio compression exercises, when appropriate, with each counterparty that is also a swap dealer or major swap participant.

(3) *Multilateral compression.* Each swap dealer and major swap participant shall establish, maintain, and follow written policies and procedures for periodically engaging in multilateral portfolio compression exercises, when appropriate, with each counterparty that is also a swap dealer or major swap participant. Such policies and procedures shall include:

(i) Policies and procedures for participation in all multilateral portfolio compression exercises required by Commission regulation or order; and

(ii) Evaluation of multilateral portfolio compression exercises that are initiated, offered, or sponsored by any third party.

(b) *Portfolio compression with counterparties other than swap dealers and major swap participants.* Each swap dealer and major swap participant shall establish, maintain, and follow written policies and procedures for periodically terminating fully offsetting swaps and for engaging in portfolio compression exercises with respect to swaps in which its counterparty is an entity other than a swap dealer or major swap participant, to the extent requested by any such counterparty.

(c) *Portfolio compression of cleared swaps.* Nothing in this section shall apply to a swap that is cleared by a derivatives clearing organization.

(d) *Recordkeeping.* (1) Each swap dealer and major swap participant shall make and maintain a complete and accurate record of each bilateral offset and each bilateral or multilateral portfolio compression exercise in which it participates.

(2) All records required to be maintained pursuant to this section shall be maintained in accordance with § 23.203 and shall be made available promptly upon request to any representative of the Commission or any applicable prudential regulator, or with regard to swaps defined in section 1a(47)(A)(v) of the Act, to any representative of the Commission, the Securities and Exchange Commission, or any applicable prudential regulator.

§ 23.504 Swap trading relationship documentation.

(a) (1) *Applicability.* The requirements of this section shall not apply to:

(i) Swaps executed prior to the date on which a swap dealer or major swap participant is required to be in compliance with this section;

(ii) Swaps executed on a board of trade designated as a contract market under section 5 of the Act or to swaps executed anonymously on a swap execution facility under section 5h of the Act, *provided that* such swaps are cleared by a derivatives clearing organization and all terms of the swaps conform to the rules of the derivatives clearing organization and § 39.12(b)(6) of this chapter; and

(iii) Swaps cleared by a derivatives clearing organization.

(2) *Policies and procedures.* Each swap dealer and major swap participant shall establish, maintain, and follow written policies and procedures reasonably designed to ensure that the swap dealer or major swap participant executes written swap trading relationship documentation with its counterparty that complies with the requirements of this section. The policies and procedures shall be approved in writing by senior management of the swap dealer and major swap participant, and a record of the approval shall be retained. Other than confirmations of swap transactions under § 23.501, the swap trading relationship documentation shall be executed prior to or contemporaneously with entering into a swap transaction with any counterparty.

(b) *Swap trading relationship documentation.* (1) The swap trading relationship documentation shall be in writing and shall include all terms governing the trading relationship between the swap dealer or major swap participant and its counterparty, including, without limitation, terms addressing payment obligations, netting of payments, events of default or other termination events, calculation and netting of obligations upon termination, transfer of rights and obligations, governing law, valuation, and dispute resolution.

(2) The swap trading relationship documentation shall include all confirmations of swap transactions under § 23.501.

(3) The swap trading relationship documentation shall include credit support arrangements, which shall contain, in accordance with applicable requirements under Commission regulations or regulations adopted by prudential regulators and without limitation, the following:

(i) Initial and variation margin requirements, if any;

(ii) Types of assets that may be used as margin and asset valuation haircuts, if any;

(iii) Investment and rehypothecation terms for assets used as margin for uncleared swaps, if any; and

(iv) Custodial arrangements for margin assets, including whether margin assets are to be segregated with an independent third party, in accordance with § 23.701(e), if any.

(4) (i) The swap trading relationship documentation between swap dealers, between major swap participants, between a swap dealer and major swap participant, between a swap dealer or major swap participant and a financial entity, and, if requested by any other counterparty, between a swap dealer or major swap participant and such counterparty, shall include written documentation in which the parties agree on the process, which may include any agreed upon methods, procedures, rules, and inputs, for determining the value of each swap at any time from execution to the termination, maturity, or expiration of such swap for the purposes of complying with the margin requirements under section 4s(e) of the Act and regulations under this part, and the risk management requirements under section 4s(j) of the Act and regulations under this part. To the maximum extent practicable, the valuation of each swap shall be based on recently-executed transactions, valuations provided by independent third parties, or other objective criteria.

(ii) Such documentation shall include either:

(A) Alternative methods for determining the value of the swap for the purposes of complying with this paragraph in the event of the unavailability or other failure of any input required to value the swap for such purposes; or

(B) A valuation dispute resolution process by which the value of the swap shall be determined for the purposes of complying with this paragraph (b)(4).

(iii) A swap dealer or major swap participant is not required to disclose to the counterparty confidential, proprietary information about any model it may use to value a swap.

(iv) The parties may agree on changes or procedures for modifying or amending the documentation required by this paragraph at any time.

(5) The swap trading relationship documentation of a swap dealer or major swap participant shall include the following:

(i) A statement of whether the swap dealer or major swap participant is an insured depository institution (as defined in 12 U.S.C. 1813) or a financial company (as defined in section 201(a)(11) of the Dodd-Frank Act, 12 U.S.C. 5381(a)(11));

(ii) A statement of whether the counterparty is an insured depository institution or financial company;

(iii) A statement that in the event either the swap dealer or major swap participant or its counterparty is a covered financial company (as defined in section 201(a)(8) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C. 5381(a)(8)) or an insured depository institution for which the Federal Deposit Insurance Corporation (FDIC) has been appointed as a receiver (the ''covered party''), certain limitations under Title II of the Dodd-Frank Act or the Federal Deposit Insurance Act may apply to the right of the non-covered party to terminate, liquidate, or net any swap by reason of the appointment of the FDIC as receiver, notwithstanding the agreement of the parties in the swap trading relationship documentation, and that the FDIC may have certain rights to transfer swaps of the covered party under section 210(c)(9)(A) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C. 5390(c)(9)(A), or 12 U.S.C. 1821(e)(9)(A); and

(iv) An agreement between the swap dealer or major swap participant and its counterparty to provide notice if either it or its counterparty becomes or ceases to be an insured depository institution or a financial company.

(6) The swap trading relationship documentation of each swap dealer and major swap participant shall contain a notice that, upon acceptance of a swap by a derivatives clearing organization:

(i) The original swap is extinguished;

(ii) The original swap is replaced by equal and opposite swaps with the derivatives clearing organization; and

(iii) All terms of the swap shall conform to the product specifications of the cleared swap established under the derivatives clearing organization's rules.

(c) *Audit of swap trading relationship documentation.* Each swap dealer and major swap participant shall have an independent internal or external auditor conduct periodic audits sufficient to identify any material weakness in its documentation policies and procedures required by this section and Commission regulations. A record of the results of each audit shall be retained.

(d) *Recordkeeping.* Each swap dealer and major swap participant shall maintain all documents required to be created pursuant to this section in accordance with § 23.203 and shall make them available promptly upon request to any representative of the Commission or any applicable prudential regulator, or with regard to swaps defined in section 1a(47)(A)(v) of the Act, to any representative of the Commission, the Securities and Exchange Commission, or any applicable prudential regulator.

§ 23.505 End user exception documentation.

(a) *For swaps excepted from a mandatory clearing requirement.* Each swap dealer and major swap participant shall obtain documentation sufficient to provide a reasonable basis on which to believe that its counterparty meets the statutory conditions required for an exception from a mandatory clearing requirement, as defined in section 2h(7) of the Act and § 39.6 of this chapter. Such documentation shall include:

(1) The identity of the counterparty;

(2) That the counterparty has elected not to clear a particular swap under section 2h(7) of the Act and § 39.6 of this chapter;

(3) That the counterparty is a non-financial entity, as defined in section 2h(7)(C) of the Act;

(4) That the counterparty is hedging or mitigating a commercial risk; and

(5) That the counterparty generally meets its financial obligations associated with non-cleared swaps. *Provided,* that a swap dealer or major swap participant need not obtain documentation of paragraphs (a)(3), (4), or (5) of this section if it obtains documentation that its counterparty has reported the information listed in § 39.6(b)(3) in accordance with § 39.6(b)(4) of this chapter.

(b) *Recordkeeping.* Each swap dealer and major swap participant shall maintain all documents required to be obtained pursuant to this section in accordance with § 23.203 and shall make them available promptly upon request to any representative of the Commission or any applicable prudential regulator, or with regard to swaps defined in section 1a(47)(A)(v) of the Act, to any representative of the Commission, the Securities and Exchange Commission, or any applicable prudential regulator.

Issued in Washington, DC, on August 24, 2012, by the Commission.

Sauntia S. Warfield,

Assistant Secretary of the Commission.

Appendices to Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants—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, O'Malia and Wetjen voted in the affirmative; no Commissioner voted in the negative.

Appendix 2—Statement of Chairman Gary Gensler

I support the final rule implementing Congress' direction that the Commission adopt rules for ''timely and accurate confirmation, processing, netting, documentation, and valuation of all swaps.'' This direction was included in the swaps market reform provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

Each of these requirements promotes crucial back office standards that will reduce risk and increase efficiency in the swaps market. These final rules are critical to the risk management of swap dealers and major swap participants and lowering their risk to the public.

The rules establish procedures to promote legal certainty by requiring timely confirmation of all swap transactions, setting forth documentation requirements for bilateral swap transactions, and requiring timely resolutions of valuation disputes. In addition, the rules enhance understanding of one counterparty's risk exposure to another, and promote sound risk management through regular reconciliation and compression of swap portfolios.

The 2008 financial crisis brought to light how large financial institutions, including AIG, had valuation disputes and other problems regarding documentation standards. These rules will directly address many of those issues, highlighting issues for senior management and regulators at an earlier stage.

The final rule builds upon extensive work by the Federal Reserve Bank of New York (FRBNY) to improve standards in the back offices of large financial institutions dealing in swaps. Beginning in 2005, the FRBNY, along with U.S. and global prudential authorities, undertook a supervisory effort to enhance operational efficiency and lower risk in the swaps market by increasing automation in swaps processing, improving documentation, and promoting the timely confirmation of trades.

CFTC staff also consulted with other U.S. and foreign financial regulators, and participated in numerous meetings with market participants. CFTC staff worked to address the more than 60 public comment letters responding to the three proposed rules comprising this final rule.

Appendix 3—Statement of Commissioner Bart Chilton

I support this second package of internal business conduct standard final rules. These rules establish a set of prudent documentation standards for registered swap dealers (SDs) and major swap participants (MSPs) while aiming to minimize the burdens on non-SDs and non-MSPs. Vibrant and liquid financial markets are necessary for economic prosperity. As shown by the 2007–2009 financial crisis, that prosperity itself is gravely threatened when the rules governing financial markets fail to curb the build-up of systemic risk. I am pleased that the preamble introducing these rules appropriately refers to the tremendous cost of the financial crisis; it is obvious that not implementing strong regulations effectuating the intent of the Dodd-Frank Act, including these final rules, would result in social costs to the American taxpayer and consumer.[152] In addition, I note that there are enormous and ongoing social costs that taxed our economy as a result of the reckless practices that became prevalent in the years before the financial crisis.

The documentation and conduct standards set forth in this release are designed to, most importantly in my opinion, reduce valuation disputes: Disputes between parties about the value of a swap or portfolio of swaps. Valuation disputes can delay the exchange of collateral. The failure to exchange collateral in a timely manner can have disastrous impacts on a firm's ability to manage its risk and allocate capital efficiently. A large, interconnected firm's inability to manage its risk and to properly allocate capital can contribute to the generation of systemic risk. All of these steps were vividly illustrated during the recent financial crisis.

American International Group's (AIG) inability to value its portfolio accurately and agree on valuations and collateral exchanges with its counterparties posed a serious problem for AIG and its counterparties during the financial crisis.[153] According to the Financial Crisis Inquiry Commission Report:

The OTC derivatives market's lack of transparency and of effective price discovery exacerbated the collateral disputes of AIG and Goldman Sachs and similar disputes between other derivatives counterparties.[154]

It is with the financial crisis in mind that I interpret the Commission's authority generally and more specifically here, under section 731 of the Dodd-Frank Act which added new section 4s(i) to the Commodity Exchange Act (CEA).[155] The portfolio reconciliation rules in section 23.502 will ensure that SDs/MSPs have portfolio valuations consistent with those of their counterparties. The portfolio compression rules in section 23.503 will reduce operational risks. The swap trading relationship documentation requirements will 23.504 will ensure that documentation practices in the swaps market cover a number of key terms. The documentation of these terms will give counterparties greater certainty as to their legal rights and responsibilities. These final rules, taken in conjunction with the Commission's other Dodd-Frank Act-related regulations, including part 43 regulations on real-time reporting and subpart H of part 23 on Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties[156] will contribute substantially to encouraging early and effective dispute resolution and will ensure the ''timely and accurate confirmation, processing, netting, documentation, and valuation of all swaps.''[157]

While these rules represent considerable progress, I believe it should not be viewed in a vacuum and that the Commission should respond nimbly in responses to changes in the market that could frustrate the underlying purpose of these final rules (and all other Commission rules for that matter). Notwithstanding the progress the Commission has made, I remain concerned that are still a number of areas that this final rule touches upon that remain areas of potential future concern:

1. *Dispute resolution and the requirement to document alternative methods for determining the value of a swap or a dispute resolution process* under regulation 23.504(b)(4)(iii).

This provision, combined with the provision in regulation 23.503(c) to report

[152] *See* infra above.

[153] *See* Testimony Before the Financial Crisis Inquiry Commission, including AIG/Goldman Sachs Collateral Call Timeline, available at *http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0701-AIG-Goldman-supporting-docs.pdf* (timeline documenting valuation disputes and collateral calls); Testimony of Joseph Cassano, available at *http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0630-Cassano.pdf;* and AIG Statement Summary, available at *http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0630-AIG-Statement-Summary.pdf.*

[154] Financial Crisis Inquiry Commission, ''The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States,'' Jan. 2011, at 353, available at *http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf* [hereinafter the FCIC Report.

[155] Pub. L. 111 (2010). CEA section 4s(i) states that each registered swap dealer and major swap participant shall conform with such standards as may be prescribed by the Commission by rule or regulation that relate to timely and accurate confirmation, processing, netting, documentation, and valuation of all swaps.

[156] *See,* specifically 17 CFR 23.431(a)(3)(i) requiring SDs and MSPs to disclose ''the price of the swap and the mid-market mark of the swap.''

[157] CEA section 4s(i).

''any valuation dispute in excess of $20,000,000'' within one business day if the dispute is with another SD/MSP or five business days for non-SDs/MSPs, should encourage the resolution of disputes. These regulations are buttressed by efforts being made by certain industry organizations. I encourage the Commission to remain vigilant in this area and to monitor the disputes reported to the Commission and to engage with the public to determine whether these regulations have their intended effect.

2. *The implied cost of credit and the requirement to document credit support arrangements* under regulation 23.504(b)(3).

I am concerned that these rules do not expressly require SDs and MSPs to document the cost of credit if such costs are a factor in the price a SD or MSP charges a counterparty. While this issue has been discussed since the earliest days of the negotiations and planning surrounding the drafting of the Dodd-Frank Act—and many market participants acknowledged that added costs would be attendant to engaging in non-cleared transactions—the Commission could provide, in this rulemaking, an additional level of transparency to transactions involving creditworthiness considerations.[158] I believe that requiring the documentation of the embedded cost of credit as a transaction fee or credit premium would have deter the practice of charging customers a price on a swap that depends on creditworthiness. My concern is mitigated somewhat by regulation 23.431(d)(2) (a provision finalized in a previous rulemaking) which requires that SDs and MSPs provide their non-SD/MSP counterparties ''with a daily mark, which shall be the mid-market mark of the swap.'' [159] Such a provision would assist an end-user to infer the embedded cost of credit they were charged by their SD or MSP counterparty. Armed with this information, I encourage market participants to seek documentation of the embedded cost of credit as a transaction fee or credit premium. As the Commission's regulations become effective, I invite the public to alert the Commission if the practice of charging a credit fee in the price (i.e., an embedded cost of credit) for a swap becomes problematic by, for example, diminishing the price discovery utility of real-time data published to the public under part 43 of the Commission's rules.

3. *Rehypothecation of uncleared swaps collateral and the requirement to document rehypothecation terms for assets used as margin for uncleared swaps* under regulation 23.504(b)(3)(iii).

This requirement is consistent with section 724(c) of the Dodd-Frank Act (adding section 4s(l)(1)(A) to the CEA) and is a welcome inclusion in these rules.[160] Rehypothecation occurs when a person uses assets held as collateral for one counterparty in transactions with another counterparty. This practice contributed to the financial crisis in a number of ways, including: (1) Rehypothecated collateral was particularly difficult to recover in bankruptcy [161] and (2) rehypothecation increases leverage in the financial system.[162] While many buy-side firms are learning from the financial crisis and requesting their collateral to be held in segregated accounts, the potential for a dealer default that could affect rehypothecated collateral still exists. In light of recent events, the Commission and the public should keep a watchful eye on the risks in this area.

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[158] *See* Better Markets comment letter.

[159] 77 FR 9733 (Feb. 17, 2012).

[160] ''A swap dealer or major swap participant shall be required to notify the counterparty of the swap dealer or major swap participant at the beginning of a swap transaction that the counterparty has the right to require segregation of the funds or other property.''

[161] This is because once the collateral is rehypothecated, then the posting party could lose their proprietary interest in the collateral and as a result in bankruptcy, such a party could fall into the category of unsecured creditors. This can delay or prevent recovery of collateral from a bankrupt counterparty.

[162] IMF researchers recently estimated that off-balance sheet funding for dealers from rehypothecation amounted to $4.5 trillion during November 2007 and that it contributed substantially to the size of the shadow banking system. *See, The (sizeable) Role of Rehypothecation in the Shadow Banking System,* Manmohan Singh and James Aitken, IMF Working Paper, July 2010, available at *http://www.imf.org/external/pubs/ft/wp/2010/wp10172.pdf.*