U.S. COMMODITY FUTURES TRADING COMMISSION

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**Division of
Market Oversight**

CFTC Letter No. 14-118
No-Action
September 19, 2014
Division of Market Oversight

No-Action Relief for Swap Execution Facilities from Certain "Block Trade" Requirements in Commission Regulation 43.2

Ladies and Gentlemen:

This letter responds to a request received by the Division of Market Oversight (the "Division") of the Commodity Futures Trading Commission (the "Commission") from the Wholesale Markets Brokers' Association for no-action relief for swap execution facilities ("SEFs") from the requirement that a swap block trade must "[o]ccur[] away from the registered [SEF's] or [DCM's] trading system or platform" (hereinafter the "'occurs away' requirement").[1]

Background

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act")[2] amended the Commodity Exchange Act ("CEA") to establish a comprehensive new regulatory framework for swaps. Among other things, the Dodd-Frank Act required the Commission to promulgate rules "to specify the appropriate time delay for reporting large notional swaps transactions (block trades) to the public."[3] As part of the rulemaking implementing that requirement, the Commission adopted § 43.2, which defines a "block trade" as, among other things, a publicly reportable swap transaction that "[o]ccurs away from the registered [SEF's] or [DCM's] trading system or platform and is executed pursuant to the registered [SEF's] or [DCM's] rules and procedures."[4] In a subsequent rulemaking establishing appropriate minimum sizes for block trades, the Commission further clarified this language by stating that "[by] definition, a block trade must occur away from the SEF['s] trading system or platform" and that "[a]ny swap that is executed on a SEF['s] or DCM's trading system or platform, regardless of whether it is for a size at or above the appropriate minimum block size for such swap, is not a block trade under this definition, and, thus, is required to be publicly disseminated in real-time pursuant to § 43.4."[5]

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1   The "occurs away" requirement is a component requirement of the block trade definition set forth in § 43.2.

2   Pub. L. 111-203, 124 Stat. 1376 (2010).

3   7 U.S.C. § 2(a)(13)(E)(iii).

4   *See* Real-Time Public Reporting of Swap Transaction Data, 77 Fed. Reg. 1182 (Jan. 9, 2012).

5   In addition to specifying the appropriate time delay for public dissemination of block trades, the Commission also promulgated rules that define the criteria for grouping swaps into separate swap categories and establishing

On April 9, 2012, the Commission published clearing member risk management regulations.[6] Among those provisions, Commission regulation 1.73 requires a Futures Commission Merchant ("FCM") that is a clearing member ("Clearing FCM") of a registered derivatives clearing organization ("DCO") to establish risk-based limits and to screen orders for compliance with those limits.[7] Staff guidance on straight-through processing issued by the Division and the Division of Clearing and Risk specifies that this requirement applies to orders for execution on or subject to the rules of a SEF or DCM, regardless of the method of execution.[8] With respect to orders for execution on a SEF, Commission regulation 37.702(b) requires a SEF to coordinate with each DCO to which it submits transactions for clearing and have rules and procedures to facilitate prompt and efficient processing by DCOs in accordance with Commission regulation 39.12(b)(7).[9] Accordingly, the staff guidance further specifies, among other things, that a SEF must facilitate pre-execution screening by each Clearing FCM on an order-by-order basis.[10]

The Division understands through discussions with market participants that adherence to the "occurs away" requirement under § 43.2 may create difficulties for SEFs to comply with §§ 1.73 and 37.702(b) when performing pre-execution credit screening. In particular, the Division understands that block trades that are privately negotiated and arranged away from a SEF's trading system or platform present the following challenges to pre-execution credit screening against FCM risk-based limits:

- An FCM may have no involvement in a block transaction occurring away from a SEF's trading system or platform and thus be unable to implement a credit screening of the trade prior to the counterparties' execution of the block.

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methodologies for setting appropriate minimum block sizes for each swap category. *See* Procedures To Establish Appropriate Minimum Block Sizes for Large Notional Off-Facility Swaps and Block Trades, 78 Fed. Reg. 32866, 32904 n.425 (May 31, 2013).

[6] *See* Customer Clearing Documentation, Timing of Acceptance for Clearing, and Clearing Member Risk Management, 77 Fed. Reg. 21,278 (Apr. 9, 2012).

[7] Commission regulation 1.73(a)(1) requires each Clearing FCM to establish risk-based limits for each proprietary account and each customer account based on position size, order size, margin requirements, or similar factors. Commission regulation 1.73(a)(2) requires each Clearing FCM to screen orders for compliance with those limits. Commission regulation 1.73(a)(2)(i) provides that when a Clearing FCM provides electronic market access or accepts orders for automated execution, the Clearing FCM shall use automated means to screen orders for compliance with such risk-based limits. Commission regulation 1.73(a)(2)(ii) provides that when a Clearing FCM accepts orders for non-automated execution, it shall establish and maintain systems of risk controls reasonably designed to ensure compliance with the limits.

[8] *See* Staff Guidance on Swaps Straight-Through Processing (Sept. 26, 2013) ("STP Guidance").

[9] Commission regulation 39.12(b)(7) requires DCOs to accept or reject all trades executed competitively on a SEF or DCM as quickly as would be technologically practicable as if fully automated systems were used.

[10] *See* Staff Guidance on Swaps Straight-Through Processing (Sept. 26, 2013).

- Many SEFs currently have no infrastructure or systematic method to facilitate the credit screening of a block trade executed pursuant to the rules of a SEF prior to the trade being reported to the SEF facility (or delivered to an affirmation or similar platform that screens the trade prior to being reported to the SEF).
- Many FCMs cannot screen SEF trades without the SEF itself facilitating the screens.

Accordingly, the requesting party contends that in order to ensure compliance with SEF and FCM obligations with respect to block trades intended to be cleared, including those arising under §§ 1.73 and 37.702(b), block trades must occur on the SEF facility. The requesting party thus asserts that no-action relief from the "occurs away" requirement under § 43.2 is needed to facilitate pre-execution credit checks and straight-through processing associated with the execution of block trades intended to be cleared.

Discussion

The Division is aware that due to the current state of technology, SEFs and FCMs may face challenges in facilitating pre-execution credit checks of block trades in a manner that is compliant with the "occurs away" requirement under § 43.2. Indeed, pursuant to this requirement, a block trade cannot be executed through a SEF's functionalities,[11] as those methods of execution are considered to constitute part of the SEF's trading system or platform. Therefore, the Division is granting time-limited no-action relief from the "occurs away" requirement under § 43.2 to provide time for the SEFs to evaluate and address the technology and other pre-execution credit check issues. The Division recognizes that trading on SEFs is evolving and technology for pre-execution credit checks is advancing. During this time Division staff will continue to review and evaluate SEF trading practices and functionalities for pre-execution credit checks as well as its other rules in these areas.

Time-Limited No-Action Relief for SEFs

Given the current difficulties in performing pre-execution credit check screenings, the Division will grant time-limited no-action relief to SEFs from the requirement under Commission Regulation 43.2 that a block trade "[o]ccur[] away from the registered [SEF's] or [DCM's] trading system or platform[.]" This no-action relief shall commence on the date of issuance of this letter and shall expire on December 15, 2015, at 12:00 am EST.

The Division will grant the above time-limited no-action relief, and will not recommend that the Commission take enforcement action against any SEF which has rules and/or procedures that provide for the use of a SEF trading system or platform to facilitate the execution of block

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[11] A SEF's methods of execution include those offered for Required Transactions—an Order Book functionality or Request for Quote (RFQ) that operates in conjunction with an Order Book, as defined in § 37.9; or any method offered for Permitted Transactions.

trades for swaps that are intended to be cleared,[12] and thus not complying with the requirement under § 43.2, provided that:

- The block trade is not executed on the SEF's Order Book functionality, as defined in § 37.3(a)(3);[13]
- The SEF adopts rules pertaining to cleared blocks that indicate that the SEF is relying on the relief provided in this no-action letter[14] and require each cleared block trade executed on a non-Order Book trading system or platform to comply with the other requirements set forth in the block trade definition in § 43.2. Specifically, the block trade must:
  1. Involve a swap that is listed on a registered SEF;
  2. Be executed pursuant to the SEF's rules and procedures;
  3. Meet the notional or principal amount at or above the appropriate minimum block size applicable to the swap; and
  4. Be reported to a swap data repository pursuant to the SEF's rules and procedures, and the Commission's rules and regulations;
- The FCM completes the pre-execution credit check pursuant to § 1.73 at the time the order for a block trade enters the SEF's non-Order Book trading system or platform;[15] and
- The block trade is subject to void *ab initio* requirements where the swap is rejected on the basis of credit.[16]

Conclusion

Market participants should be aware that the no-action position taken herein does not excuse affected persons from compliance with any other applicable requirements of the CEA or the Commission's regulations thereunder, in particular, the applicable swap data reporting requirements, clearing requirements, pre-execution credit check requirements, and straight-

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[12] Swaps that are intended to be cleared are swaps that are (i) of a type accepted for clearing by a DCO, and (ii) intended to be submitted for clearing contemporaneously with execution.

[13] The Division notes that while block trades may not be facilitated through a SEF's Order Book functionality, pursuant to this no-action letter, SEFs are permitted to use RFQ functionalities to facilitate the execution of a block trade. Also the Division notes that a block trade executed through a SEF's RFQ functionality pursuant to this no-action relief would not be subject to the minimum participant requirement set forth in §37.9(a)(3). Finally, the Division notes that trades above the minimum block size may occur on the SEF's Order Book however they will not receive treatment as block trades and will not be afforded a reporting time delay.

[14] These rules should include a citation to this no-action letter as "NAL 14-118, expiring December 15, 2015."

[15] Consistent with the STP Guidance, the §1.73 credit check must be done before execution, no matter the means of execution. To the extent parties to a swap do not use the SEF functionality provided by this letter, the parties to the swap still must ensure the §1.73 check occurs before execution.

[16] *See* Staff Guidance on Swaps Straight-Through Processing (Sept. 26, 2013). Staff reminds the SEFs that pursuant to Commission regulation 43.3(e)(3), a SEF is required to submit a cancellation message to the appropriate SDR for a swap transaction executed on or pursuant to the rules of the SEF, including those transactions void *ab initio*.

through processing requirements.[17] This letter, and the no-action position taken herein, represents the views of the Division only, and does not necessarily represent the positions or views of the Commission or of any other division or office of the Commission's staff. As with all no-action letters, the Division retains the authority to condition further, modify, suspend, terminate or otherwise restrict the terms of the no-action relief provided herein, in its discretion.

If you have any questions concerning this correspondence, please contact Nancy Markowitz, Deputy Director, Division of Market Oversight, at (202) 418-5453 or nmarkowitz@cftc.gov, Aaron Brodsky, Special Counsel, Division of Market Oversight, at (202) 418-5349 or abrodsky@cftc.gov, or Roger Smith, Special Counsel, Division of Market Oversight, at (202) 418-5344 or rsmith@cftc.gov.

Sincerely,

Vincent A. McGonagle
Director
Division of Market Oversight

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[17] The applicable swap data reporting requirements are set forth under parts 43, 45, and 50 of the Commission's regulations. The applicable clearing requirements are set forth under CEA section 2(h)(1) and part 50 of the Commission's regulations. The applicable pre-execution credit check requirements are set forth under § 1.73 of the Commission's regulations. The applicable straight-through processing requirements are set forth under § 1.74, § 37.702(b), and § 39.12(b)(7) of the Commission's regulations.