



## U.S. COMMODITY FUTURES TRADING COMMISSION

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Division of Clearing and  
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CFTC Letter No. 15-51  
Interpretation  
September 18, 2015  
Division of Clearing and Risk

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Re: Request for Interpretation Regarding the Applicability of Commission Regulation 37.3(a)(1) and Section 2(h)(8) of the Commodity Exchange Act to Derivatives Clearing Organizations and their Clearing Members

Dear Ms. Williams:

This letter responds to your request for an interpretation by the Division of Clearing and Risk and the Division of Market Oversight (collectively, the “**Divisions**”) regarding Commodity Futures Trading Commission (“**Commission**”) Regulation 37.3(a)(1).<sup>1</sup> By letter dated September 2, 2015, you have asked for clarification as to whether a derivatives clearing organization’s (“**DCO**”) use of a “firm or forced trades” process to help determine end-of-day swap pricing information would require the DCO to register with the Commission as a swap execution facility (“**SEF**”). You have also asked whether the swaps resulting from such a process would be subject to the trade execution requirement of Section 2(h)(8) of the CEA.<sup>2</sup> Finally, you have asked for confirmation that the DCO would be the counterparty required under Part 45 of the Commission’s regulations to report data for swaps created by a firm or forced trades process.

### Background

Regulation 37.3(a)(1) requires “[a]ny person operating a facility that offers a trading system or platform in which more than one market participant has the ability to execute or trade swaps with more than one other market participant on the system or platform” to register the facility as a SEF or as a designated contract market (“**DCM**”). This regulation implements Section 5h(a)(1) of the CEA,<sup>3</sup> the goal of which is “to promote the trading of swaps on swap

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<sup>1</sup> Commission regulations referred to herein are found at 17 C.F.R. ch. 1 (2015).

<sup>2</sup> 7 U.S.C. § 2(h)(8).

<sup>3</sup> 7 U.S.C. § 7b-3(a)(1).

execution facilities and to promote pre-trade price transparency in the swaps market.”<sup>4</sup> As the Commission noted when Regulation 37.3(a)(1) was adopted, by requiring trading of swaps on SEFs and DCMs, “all market participants will benefit from viewing the prices of available bids and offers and from having access to transparent and competitive trading systems or platforms.”<sup>5</sup>

DCOs help mitigate risk in the derivatives markets by, among other things, reducing counterparty credit risk and providing an organized mechanism for collateralizing risk exposures.<sup>6</sup> One method of collateralizing risk exposures is through variation margin, which is “a payment made by a party to a swap to cover the current exposure arising from changes in the market value of the position since the trade was executed or the previous time the position was marked to market.”<sup>7</sup>

The amount of variation margin a party to a swap pays to the DCO is based on the changing price or value of the swap. Some DCOs use a “firm or forced trades” process to determine the price of certain swaps for which public market prices are not available. Although the details of the relevant procedures vary, a DCO using a firm or forced trades process will generally require its clearing members to submit both bid and ask prices for the relevant swaps. The DCO matches the bid and ask prices submitted by the various clearing members and, under certain conditions, requires a clearing member to buy or sell a swap at a price based on the clearing member’s submitted price. This process may include a random component; for example, at least one DCO only effects firm or forced trades on certain trading days, some of which are determined randomly and are only identified to members after the DCO has effected the trades. The firm or forced trades process is intended to ensure the integrity of end-of-day pricing by incentivizing clearing members to submit fair and accurate bid and ask prices.

A DCO’s obligation to pay or collect variation margin is embodied in Regulation 39.14(b), which requires that a DCO “effect a settlement with each clearing member at least once each business day.” Regulation 39.13(g)(5) requires that a DCO have “a reliable source of timely price data” and implement “written procedures and sound valuation models for addressing circumstances where pricing data is not readily available or reliable.” Pricing data may not be readily available or reliable where there is no continuous liquid market for a given product,<sup>8</sup> and you have represented that a firm or forced trades process is a way in which a DCO that clears such products may attempt to comply with its regulatory obligations.

Because a firm or forced trades process results in the creation of a new swap, this process potentially implicates the clearing requirement of Section 2(h)(1) of the CEA and the trade execution requirement of Section 2(h)(8) of the CEA. Section 2(h)(1) provides that “[i]t shall be unlawful for any person to engage in a swap unless that person submits such swap for clearing to a

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<sup>4</sup> Section 5h(e) of the CEA, 7 U.S.C. § 7b–3(e).

<sup>5</sup> Core Principles and Other Requirements for Swap Execution Facilities, 78 Fed. Reg. 33,476, 33,477 (June 4, 2013).

<sup>6</sup> See, e.g., Derivatives Clearing Organization General Provisions and Core Principles, 76 Fed. Reg. 69334 (Nov. 8, 2011).

<sup>7</sup> Regulation 1.3(fff).

<sup>8</sup> See Risk Management Requirements for Derivatives Clearing Organizations, 76 Fed. Reg. 3698, 3705 (Jan. 20, 2011).

[DCO] that is registered under [the CEA]...if the swap is required to be cleared.”<sup>9</sup> Section 2(h)(8) of the CEA requires that a swap subject to the Section 2(h)(1) clearing requirement must be executed on a DCM or SEF, unless no DCM or SEF makes such swap available to trade or such swap qualifies for the clearing exception under Section 2(h)(7) of the CEA.<sup>10</sup>

Finally, Part 45 of the Commission’s regulations requires that certain data pertaining to swaps be reported to swap data repositories (“**SDRs**”). Regulation 45.8<sup>11</sup> specifies which swap counterparty is the “reporting counterparty,” responsible for reporting such data. The Commission has proposed amending Regulation 45.8 to require, among other things, that the relevant DCO report the necessary data for certain swaps.<sup>12</sup>

The Division of Market Oversight has previously issued and extended time-limited no-action relief from certain requirements as applied to a firm or forced trades context.<sup>13</sup>

## Discussion

You have inquired whether a DCO’s use of a firm or forced trade process may require it to register as a SEF on the basis that it operates “a facility that offers a trading system or platform in which more than one market participant has the ability to execute or trade swaps with more than one other market participant on the system or platform” under Regulation 37.3(a)(1).

In connection with the SEF registration requirement, the Commission noted, both when proposing and adopting the SEF regime under Part 37, that it “views the CEA section 5h(a)(1) registration requirement as applying only to facilities that meet the SEF definition in CEA section 1a(50).” The Commission added that Section 1a(50) defines a SEF as, in part, “a trading system or platform in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants in the facility or system, through any means of interstate commerce....”<sup>14</sup>

A SEF provides participants “the ability to execute or trade swaps by accepting bids and offers made by multiple participants.” That implies a functionality that market participants may exercise in their discretion to submit orders for execution and enter into desired trades. Here, in the context of a DCO’s use of a firm or forced trades process, DCO clearing members are not

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<sup>9</sup> Section 2(h)(1)(a) of the CEA, 7 U.S.C. § 2(h)(1)(a). Regulation 39.5 specifies the process through which the Commission determines whether a swap, or a group, category, type, or class of swaps, is required to be cleared.

<sup>10</sup> Regulation 37.10 specifies the process through which a SEF makes a swap available to trade and, therefore, subject to the CEA Section 2(h)(8) trade execution requirement.

<sup>11</sup> Regulation 45.8.

<sup>12</sup> Amendments to Swap Data Recordkeeping and Reporting Requirements for Cleared Swaps, 80 Fed. Reg. 52,544 (proposed Aug. 31, 2015).

<sup>13</sup> See CFTC Letter No. 14-119 (Sept. 29, 2014), available at:

<http://www.cftc.gov/LawRegulation/CFTCStaffLetters/14-119>; CFTC Letter No. 13-86 (Dec. 31, 2013), available at:

<http://www.cftc.gov/LawRegulation/CFTCStaffLetters/13-86>; CFTC Letter No. 13-36 (June 27, 2013), available at:

<http://www.cftc.gov/LawRegulation/CFTCStaffLetters/13-36>; and CFTC Letter No. 12-59 (Dec. 19, 2012), available at <http://www.cftc.gov/LawRegulation/CFTCStaffLetters/12-59>.

<sup>14</sup> See Core Principles and Other Requirements for Swap Execution Facilities, 78 Fed. Reg. 33476 at 33481 (June 4, 2013) (internal citations omitted); see also 76 Fed. Reg. 1214, 1219 (Jan. 7, 2011).

seeking to enter into a swap transaction and may not wish to do so. Instead, they are placed into trades with a counterparty selected by the DCO as part of a process in which clearing members are required to participate, in order for the DCO to fulfill its regulatory obligations. Furthermore, a DCO using a firm or forced trades process does not provide its participants the ability to accept bids and offers made by multiple participants. Instead, the DCO requires its clearing members to submit prices and then, based on those submissions, selects clearing members to enter into swaps, whether those clearing members wish to enter into a swap or not. A clearing member may be required to enter into a swap at a price based on its submission to incentivize clearing members to offer fair and accurate pricing data, but clearing members are not placing bids and offers through the DCO.

The regulatory requirements imposed on SEFs further illustrate that the Commission did not contemplate DCOs registering as SEFs in connection with an activity such as the firm or forced trade process. SEFs are required to ensure that their operations comply with a minimum trading functionality requirement<sup>15</sup> including provision of an order book.<sup>16</sup> In connection with this requirement, the Commission has stated that “an acceptable SEF system or platform must provide at least a minimum functionality to allow market participants the ability to make executable bids and offers, and to display them to all other market participants on the SEF.”<sup>17</sup> A DCO operating a firm or forced trade process cannot provide for transparent bids and offers, as doing so would leave its end-of-day pricing process exposed to manipulation. In addition, the relatively small number of trades that DCOs generate pursuant to their end-of-day pricing procedures, by their very nature as trades made on a somewhat randomized basis, cannot be conducted openly on a SEF.

Finally, the Divisions note that because DCOs are already regulated by the Commission, their end-of-day pricing practices, which they have implemented to comply with the pricing and settlement requirements discussed above, are already subject to Commission examination and supervision. The Divisions do not intend to suggest that registration with the Commission in one capacity, such as registration as a DCO, excuses a registrant from the requirement to comply with other applicable Commission regulations or excuses a registrant from applying for registration in such additional capacities as its activities warrant. A registered swap dealer, for example, that chooses to offer a multilateral platform to execute or trade swaps would not be excused from the SEF registration requirement as a result of its pre-existing status as a Commission registrant. However, given the other factors discussed above, the fact that a DCO which uses a firm or forced trades process is subject to examination and oversight by Commission staff provides comfort that the absence of SEF registration does not mean that the relevant activities will avoid regulatory scrutiny.

In addition, a swap generated as a result of a firm or forced trade process is not subject to the clearing and trade execution requirements. Even if a swap created through a firm or forced trade process meets the specifications of a swap required to be cleared,<sup>18</sup> the fact that the DCO itself is a counterparty to the swap means that the swap cannot be submitted to the DCO for clearing. Therefore, such swaps cannot logically be subject to the clearing requirement.

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<sup>15</sup> Regulation 37.3(a)(2).

<sup>16</sup> Regulation 37.3(a)(3).

<sup>17</sup> 78 Fed. Reg. 33,476 at 33,484.

<sup>18</sup> Regulation 50.4.

Moreover, the trade execution requirement only applies when the relevant swap is subject to the clearing requirement. Thus, swaps created through a firm or forced trade process are not subject to the trade execution requirement.

Swaps created by the firm or forced trade process would qualify as “clearing swaps,” which the Commission has proposed to be defined as swaps “created pursuant to the rules of a [DCO] that [have] a [DCO] as a counterparty,”<sup>19</sup> and must be reported as required under the Part 45 swap data reporting regulations. The Divisions note that the Commission has proposed amending Regulation 45.8 to require that the DCO be the reporting counterparty for clearing swaps.

### Conclusion

Accordingly, the Divisions do not interpret Section 5h(a)(1) of the CEA and Regulation 37.3(a)(1) as requiring a DCO to register as a SEF solely due to its use of a firm or forced trades process, and do not interpret Sections 2(h)(1) and 2(h)(8) of the CEA as requiring a swap generated as a result of such a process to be subject to the clearing and trade execution requirements. Finally, the Divisions agree that the DCO should be the reporting counterparty for swaps created by the firm or forced trades process for purposes of Part 45 of the Commission’s regulations.

This letter represents the position of the Divisions only and does not necessarily represent the views of the Commission or those of any other division or office of the Commission. Should you have questions regarding this matter, please contact Brian Baum, Special Counsel (bbaum@cftc.gov, 202-418-5654) or Riva Adriance, Senior Special Counsel (radriance@cftc.gov, 202-418-5494).

Sincerely,

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<sup>19</sup> See proposed amendments to Regulation 45.1, 80 Fed. Reg. 52,544, *supra* note 12, at 52,572.