



U.S. COMMODITY FUTURES TRADING COMMISSION

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Division of
Market Oversight

CFTC Letter No. 13-81
No-Action
December 23, 2013
Division of Market Oversight

Re: Time-Limited No-Action Relief from Required Transaction Execution Methods for Transactions that Result from Basis Risk Mitigation Services

Ladies and Gentlemen,

This letter is in response to a request dated July 31, 2013 and supplement dated December 6, 2013 (together the “Request”) from ICAP plc (“ICAP”), both to the Division of Market Oversight (the “Division”) of the Commodity Futures Trading Commission (the “Commission”), in which ICAP requested relief from the Division in connection with certain “basis risk reduction services” offered by ICAP.¹ Specifically, ICAP requested that: (1) Required Transactions² that result from basis risk reduction services may be executed in accordance with a swap execution facility’s (“SEF”) basis risk reduction service rule, as described in the Request, rather than on an Order Book or RFQ System and (2) in the event the Division grants the requested relief with respect to item (1) above, ICAP may continue its basis risk reduction services operations as they occur today until January 31, 2014 in order to permit it to effectuate an orderly transition of those operations to the ICAP SEF in accordance with the specifications set forth in the Request (and/or as otherwise specified by the Division in its provision of relief).³

After consideration of ICAP’s request, and subject to the conditions specified below, this letter provides relief to item 1 of its request. As discussed below, The Division notes that, although the relief contained herein was requested by a particular entity, such relief is available to all entities that provide basis risk mitigation services, subject to the conditions specified herein.

¹ ICAP refers to its risk mitigation service as its “basis risk reduction services.” The Division is not making any determination in this letter as to whether or not such services reduce risk or rather manage risk.

² For the purposes of the Request, the terms “Required Transaction,” “Permitted Transaction,” “Order Book,” “RFQ System” and “Risk Mitigation Services” have the meaning ascribed to them in the Commission’s final SEF rule. Core Principles and Other Requirements for Swap Execution Facilities, 78 FR 33476 (Jun. 4, 2013).

³ In addition to the two requests noted here, ICAP asked for relief from the reporting requirements of Part 43. The Division does not believe that such relief is appropriate at this time; consequently this letter neither addresses nor grants any such relief, leaving Part 43 applicable under the terms contained therein.

Factual Background

ICAP states that swaps are generally structured with long durations with periodic payments and fixings of cash flows on a transaction by transaction basis. ICAP also states that for two equal and offsetting swap transactions entered on different dates where one is a “buy” and the other is a “sell,” the parties are exposed to the quarterly re-pricing timing mismatch on each cash flow for the life of those transactions. ICAP notes that these timing mismatches can create sizeable unwanted secondary basis risks when considering all swap portfolios globally.

ICAP represents that its basis risk reduction service reduces the basis risk from reference price quarterly re-pricing timing mismatches on swaps. ICAP also represents that its basis risk reduction service operates according to the following parameters:

- They are multilateral;
- They are non-continuous and not-real time – they operate according to schedules published in advance;
- The service has written processes which it uses to construct and establish the curves used in the particular basis risk reduction cycles, and it sets the curve and price for all trades prior to each run;
- Records are kept of survey communications on regulatory approved storage standards and of all derived basis risk reduction services curves;
- Participants are given the curve and price for all trades in advance of deciding whether to participate in a run, and do not post priced bids or offers in order to participate;
- They are market risk neutral across each cycle for each participant;
- A minimum number of market participants for a risk reduction cycle are generally at least 5 participants for the 4 major currencies and at least 3 for non-major currencies.
- Participants submit their portfolio and a limited set of criteria to be respected by the risk reduction algorithm, such as counterparty credit limits and portfolio risk tolerances;⁴
- The service determines the series of risk mitigating trades for each participant;
- The risk reduction cycles are binding on an “all or nothing” basis across all participants upon the participants submitting their portfolios to the service. A participant cannot pick and choose individual transactions from the series of risk mitigating trades provided to it by the service;
- The service is designed to address basis risk as a result of historical transactions and on a portfolio, rather than individual position, basis.

Applicable Regulatory Requirements and Analysis

⁴ ICAP participants decide which trades from their portfolio will be submitted in connection with the basis risk reduction cycle. Participants are not obligated to submit all trades from their portfolio which might be eligible for the basis risk reduction cycle and are not guaranteed that any of the positions which are submitted will be transacted.

On June 4, 2013, the Commission finalized rules that establish registration and operation requirements for SEFs, in accordance with certain statutory provisions enacted by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”).⁵ Among other requirements, the final rules establish: (1) the types of entities that must register with the Commission as a SEF;⁶ and (2) the minimum trading functionalities that a registered SEF must provide to market participants. With respect to minimum trading functionalities, Section 37.3(a)(2) of the Commission’s regulations requires all registered SEFs to offer an Order Book⁷ to market participants. The final rules further prescribe that SEFs must offer either (1) an Order Book or (2) a Request for Quote (“RFQ”) system⁸ that operates in conjunction with an Order Book to facilitate Required Transactions, which is defined as any transaction involving a swap that is subject to the trade execution requirement in Section 2(h)(8) of the Commodity Exchange Act (“CEA”).⁹

The Commission has determined that pursuant to Section 37.3(a)(1) of the Commission’s regulations, entities providing “risk mitigation services” must register as SEFs because they meet the definition of a SEF in Section 1a(50) of the CEA.¹⁰ As noted in the final SEF rules, the Commission understands that risk mitigation services enable market participants to manage exposures to market, credit, and other sources of risk in their portfolios.¹¹ ICAP’s risk mitigation service sets the pricing curve for all swaps executed through the service based on a survey of market making entities, such as banks, or other entities that are willing to provide quotes, as well as price quotes on designated contract markets.¹² The Division recognizes that other risk mitigation services could operate in accordance with SEF rules whereby swap transaction prices

⁵ See generally 78 FR 33476.

⁶ Pursuant to Section 37.3(a)(1) of the Commission’s regulations, any 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 must register with the Commission as either a SEF or a designated contract market (“DCM”).

⁷ Section 37.3(a)(3) of the Commission’s regulations defines “Order Book” as: (i) an electronic trading facility, as defined in Section 1a(16) of the Commodity Exchange Act (“CEA”); (ii) a trading facility, as defined in Section 1a(51) of the CEA; or (iii) a trading system or platform in which all market participants in the trading system or platform have the ability to enter multiple bids and offers, observe or receive bids and offers entered by other market participants, and transact on such bids and offers.

⁸ Section 37.9(a)(3) of the Commission’s regulations defines “Request for Quote” system as a trading system or platform in which a market participant transmits a request for a quote to buy or sell a specific instrument to no less than three market participants in the trading system or platform, to which all such market participants may respond.

⁹ Section 2(h)(8) of the CEA—the trade execution requirement—generally requires counterparties to execute swaps subject to the clearing requirement on a DCM or a SEF, unless no DCM or SEF makes the swap available to trade or the swap is subject to the clearing exception under CEA Section 2(h)(7).

¹⁰ 78 FR at 33483.

¹¹ *Id.*

¹² See also, *id.* at 33480.

are determined by the risk mitigation algorithm based on bids and offers submitted by market participants. In either pricing method, all prospective market participants in a particular risk mitigation session are first shown the pricing curve.¹³ Subsequently, the prospective market participants provide the risk mitigation service provider with data about their swap positions and their risk tolerances (*i.e.*, their trading interests).¹⁴ The risk mitigation service provider then runs an algorithm, which produces a set of proposed transactions for each market participant.¹⁵ Each market participant must agree to execute each proposed transaction in order for the proposed transactions from the risk mitigation session to be executed.¹⁶ Otherwise, any market participant's determination not to execute a single swap proposed by the algorithm automatically terminates the risk mitigation session without permitting the execution of any single swap, and the participants' existing swaps remain in effect.¹⁷

ICAP acknowledges in its Request that it intends to execute swaps resulting from its basis risk reduction service on a SEF, in accordance with the Commission's final SEF rules. However, ICAP also states that certain aspects of the final SEF rules would be incompatible with the manner by which basic risk reduction services operate, asserting that its basis risk reduction service cannot accomplish its fundamental purpose of basis risk reduction if the execution of Required Transactions must occur on an Order Book or RFQ System as required by the final SEF rules. As such, ICAP requests that Required Transactions that result from basis risk reduction services may be executed on a SEF in accordance with a SEF's basis risk reduction service rule, as described in the Request, rather than on an Order Book or RFQ System.

Division No-Action Position

The Division notes that basis risk mitigation services may provide benefits that are consistent with the objectives of the Dodd-Frank Act by helping market participants manage their risks. Accordingly, the Division will not recommend that the Commission take an enforcement action against any registered SEF that provides a basis risk mitigation service, *i.e.*, a service that manages the basis risk from reference price quarterly re-pricing timing mismatches on swaps,¹⁸ for Required Transactions for failure to comply with the requirements under Section 37.9(a)(2) of the Commission's regulations, provided that the basis risk mitigation service operates in accordance with a SEF rule that meets all of the following conditions:

- 1) The SEF must provide impartial access to its platform consistent with the requirements of Commission Regulation 37.202(a) and with any Commission- or Commission staff-

¹³ 78 FR 33480.

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Id.* at 33481.

¹⁷ *Id.*

¹⁸ Other mismatches that are managed as part of a basis risk mitigation service include one month and six month repricings, net mismatches in aggregate exposures over specific periods of time, mismatches in CDX series and exposures, and mismatches in NDF and inflation fixings.

issued guidance and interpretations thereto.¹⁹ In addition, the SEF must provide sufficient notice to allow all market participants the ability to choose to participate in each basis risk mitigation session.

- 2) In order for any market participant to participate in a particular SEF's basis risk mitigation session, the SEF must determine that the market participant holds the swap positions underlying the risk position that it submits to the portfolio risk mitigation session, and the market participant's intent in participating in the risk mitigation session is to reduce and mitigate the basis risk associated with that risk position and not to increase its exposure to market risk. In making such a determination, the SEF may rely upon a self-certification by the submitting market participant or on SEF rules or documentation that condition participation on participants making the aforementioned representations.
- 3) Each market participants' submitted swap portfolios must contain at least two positions, and the algorithm supporting the basis risk mitigation session must generate only risk mitigation or risk reduction opportunities for each participant.
- 4) Upon the conclusion of the time period for participants to submit swap portfolio information or trading interests to the SEF, the session's participants may not amend such information.
- 5) In order for a SEF to run a basis risk mitigation session, swap portfolios from at least 5 market participants must be utilized by the SEF's pre-determined risk mitigation algorithm to run for that particular basis risk mitigation session for swaps involving EUR, USD, GBP, and JPY interest-rate currencies, and at least three participants for swaps involving all other currencies and CDX. In addition, the SEF should adopt rules specifying the minimum notional size of risk exposures for the swap portfolios submitted to a basis risk mitigation session. Such minimum notional size could vary with the asset class and currency.
- 6) In order for any transaction to be executed during a particular basis risk mitigation session, each participant in that session must agree to simultaneously execute every transaction that has been proposed by the SEF's pre-determined risk mitigation algorithm. Any participant's determination not to execute any transaction proposed by the SEF's pre-determined risk mitigation algorithm shall automatically terminate the basis risk mitigation session without the execution of any transaction. Transactions from the risk mitigation session are market risk neutral, market risk mitigating or market risk reducing to every participant, and every buy transaction should be accompanied by at least one sell transaction, and vice versa.

¹⁹ 17 CFR 37.202(a); see e.g. *Division of Clearing and Risk, Division of Market Oversight and Division of Swap Dealer and Intermediary Oversight Guidance on Application of Certain Commission Regulations to Swap Execution Facilities*, November 14, 2013 (available at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/dmostaffguidance111413.pdf>).

- 7) If swap transaction prices are determined based on a pricing curve established by the SEF based on information from external sources, such as a mid-market pricing curve established by a survey of market participants, and not based on bids or offers submitted to the SEF, the methodology used to determine the pricing curve must be set forth in the SEF's rules pertaining to its basis risk mitigation service. This methodology must include, if applicable, any swap transactions used in setting the pricing curve and how the prices from those transactions are used in setting the pricing curve, and/or the methodology of any surveys of market participants that the SEF uses in setting the pricing curve, including the number of market participants surveyed and how the quotes obtained from the survey are used in setting the pricing curve. In conducting any surveys of market participants to establish a pricing curve, neither a SEF nor its employees may attempt to coerce or pressure a market participant to alter a genuinely held view or offer a view of the market to the market participant participating in the survey, nor may a SEF or its employees seek or knowingly receive a quote intended to favor a particular participant or participants. In addition, the methodology should not be readily susceptible to manipulation, and the survey process must be recorded by the SEF. To the extent a SEF relies on surveys of market participants to build the curve, the SEF must obtain from the market participant and retain a written or electronic record of the basis of the market participant's quote. A SEF shall otherwise institute and maintain internal controls, policies and procedures to ensure that formation of the pricing curve is not influenced by internal or external conflicts of interest or other illegitimate factors. The SEF must maintain and retain, in accordance with Commission Regulation 1.31, books and records, including recordings, of the inputs used to generate the pricing curve and the sources for the inputs, including, but not limited to, the identities of the market participants and their respective responses to any surveys.
- 8) When swap transaction prices are determined based on a pricing curve established by the SEF, such a pricing curve must be disseminated to each market participant with access to the SEF's trading system or platform as well as made available through publication before participants are permitted to submit orders to a risk mitigation session. If such a pricing curve is updated during the period when participants are submitting their orders to the risk mitigation session, the SEF's rules must allow market participants to modify, cancel, and submit orders after any update to the pricing curve and before the pre-determined basis risk mitigation algorithm is run.
- 9) During the period when participants are submitting their swap portfolio information or trading interests, the SEF must make available through publication the indicative aggregate size of transactions in each different swap at periodic intervals. If the swap transaction prices are determined by the basis risk mitigation algorithm based on bids and offers submitted by participants, the SEF must disseminate the indicative transaction price and indicative aggregate size of transactions in each different swap at periodic intervals.
- 10) Every transaction in every basis risk mitigation session must be executed at non-discriminatory prices determined pursuant to Conditions 7-9 above. All trades by all participants in any specific swap should be at a uniform price. If prices are determined

based on a pricing curve published by the basis risk mitigation service pursuant to Conditions 7-9 above, trades executed at the uniform price should be the same as specified in the pricing curve for that specific swap.

- 11) The basis risk mitigation session, if it results in the execution of swaps (as described above in Condition 6), does not occur more frequently than once per week per asset class/currency/fixing tenor or reference credit, as defined in Section 43.2 of the Commission's regulations.²⁰
- 12) The SEF providing the basis risk mitigation service must have submitted to the Commission pursuant to the requirements of Part 40 of the Commission's regulations rules and procedures governing the operation of such service, and such rules and procedures must be available to all market participants with access to the SEF.

This relief is time-limited until 12:59 p.m. eastern time on December 31, 2014.

This letter, and the positions taken herein, represent the views of the Division only, and do not necessarily represent the position or view of the Commission or of any other division or office of the Commission. The relief issued by this letter is only from compliance with the requirements under Section 37.9(a)(2) of the Commission's regulations. This letter does not excuse persons relying on it from compliance with any other applicable requirements contained in the CEA or in the Commission's regulations thereunder, and persons may be subject to an enforcement action by the Commission for violation of the CEA or the Commission's regulations, including, but not limited to, manipulation of any pricing curve generated in condition 4. 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. The Division specifically notes that it may revisit this no-action relief if trading in a particular CEA Section 2(h)(8) trade execution mandate swap is done predominantly through a basis risk mitigation service rather than through either the SEF's Order Book or, if applicable, the SEF's RFQ System operating in conjunction with the Order Book.

If you have any questions regarding the content of this staff no-action letter, please contact Riva Spear Adriance, Division of Market Oversight at 202-418-5494 or radriance@cftc.gov.

Sincerely,

Vincent A. McGonagle
Director
Division of Market Oversight

²⁰ Section 43.2 of the Commission's regulations defines "asset class" as a broad category of commodities, including, without limitation, any "excluded commodity" as defined in Section 1a(19) of the CEA, that share common characteristics underlying a swap. The asset classes include interest rate, foreign exchange, credit, equity, other commodity and such other classes that may be determined by the Commission.