



U.S. COMMODITY FUTURES TRADING COMMISSION

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Division of Market Oversight

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No-Action
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Division of Market Oversight

Time-Limited No-Action Relief from the Commodity Exchange Act Section 2(h)(8) for Swaps Executed Between Certain Affiliated Entities Not Electing Commission Regulation § 50.52

Dear Mr. Pickel:

This letter responds to a request received from the International Swaps and Derivatives Association (“ISDA”), dated February 19, 2014, to the Division of Market Oversight (the “Division”) of the Commodity Futures Trading Commission (the “Commission”). Among other requests,¹ ISDA seeks no-action relief from the trade execution requirement in Commodity Exchange Act (“CEA”) section 2(h)(8) on behalf of members and other market participants that engage in “inter-affiliate”² swaps.

Background

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”)³ amended the CEA to establish a comprehensive new regulatory framework for swaps. Among other things, CEA section 2(h)(8) requires that transactions involving swaps subject to the CEA section 2(h)(1) clearing requirement be executed on a designated contract market (“DCM”) or swap execution facility (“SEF”), unless no DCM or SEF makes such swaps available to trade or such swaps qualify for the clearing exception under CEA section 2(h)(7) (the “trade execution requirement”).⁴

¹ ISDA requested the Commission to establish an exemption for “inter-affiliate” swaps from the trade execution requirement pursuant to the Commission’s exemptive authority under CEA section 4(c), or in the alternative, to provide equivalent no-action relief. ISDA also requested the Commission to extend the time-limited alternative compliance frameworks, set forth in § 50.52(b)(4)(ii)-(iii) of the Commission’s regulations, that are available to certain eligible affiliate counterparties that elect the inter-affiliate exemption from the clearing requirement, or in the alternative, to provide equivalent no-action relief. In this letter, the Division will only address the request for relief from the trade execution requirement set forth under CEA section 2(h)(8). This letter does not address the requests related to the clearing requirement set forth under CEA section 2(h)(1) and part 50 of the Commission’s regulations.

² The relief stated herein applies only to entities that meet the definition of “eligible affiliate counterparty” in § 50.52(a)(1)-(2) of the Commission’s regulations. See infra note 7 and accompanying text.

³ Pub. L. 111-203, 124 Stat. 1376 (2010).

⁴ 7 U.S.C. § 2(h)(8).

All transactions involving swaps that are subject to the trade execution requirement must be executed on or pursuant to the rules of a DCM or a SEF. On a SEF, such swaps must be executed in accordance with the execution methods prescribed by § 37.9(a)(2) of the Commission's regulations. Swaps that are subject to the trade execution requirement and traded on a SEF are defined as Required Transactions by § 37.9(a)(1). Under § 37.9(a)(2), Required Transactions that are not block trades, as defined under § 43.2 of the Commission's regulations, must be executed on a SEF by either (1) an Order Book, as defined in § 37.3(a)(3); or (2) a Request for Quote System ("RFQ"), as defined in § 37.9(a)(3), that operates in conjunction with an Order Book. On a DCM, such swaps must be executed pursuant to subpart J of part 38 of the Commission's regulations, which implements DCM Core Principle 9 under section 5(d)(9) of the CEA.⁵

The Commission previously determined that swaps entered into by eligible affiliate counterparties that elect and comply with the provisions of the inter-affiliate exemption from the clearing requirement under § 50.52 of the Commission's regulations would not be subject to the trade execution requirement.⁶ Section 50.52(a) of the Commission's regulations defines eligible affiliate counterparties to be related entities, in which (1) one counterparty, directly or indirectly, holds a majority ownership interest in the other counterparty, and the counterparty that holds such majority interest reports its financial statements on a consolidated basis under Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS), and the statements include the financial results of the majority-owned counterparty; or (2) a third party, directly or indirectly, holds a majority ownership interest in both counterparties, and the third party reports its financial statements on a consolidated basis under GAAP and IFRS, and the statements include the financial results of both counterparties.⁷

Requested Relief

ISDA seeks relief from the trade execution requirement for inter-affiliate swap transactions that are subject to the clearing requirement. ISDA asserts that applying the trade execution requirement to inter-affiliate swap transactions, even those that must be cleared, conflicts with the reasons that affiliates execute such transactions and will impose unnecessary costs and inefficiencies without any related benefits. ISDA states, for example, that affiliates execute swap transactions that often are not intended to be arm's-length, but instead are intended to manage risk between the affiliates. ISDA asserts, accordingly, that requiring such transactions

⁵ 7 U.S.C. § 7(d).

⁶ 78 Fed. Reg. 33606 n.1. Sections 50.52(b) through (d) of the Commission's regulations establish the conditions, including reporting requirements, centralized risk management requirements, documentation requirements, and outward-facing swap clearing requirements that eligible affiliate counterparties must satisfy to elect the inter-affiliate exemption from required clearing. 17 C.F.R. § 50.52(b)-(d).

⁷ 17 C.F.R. § 50.52(a)(1)(i)-(ii). A counterparty or third party directly or indirectly holds a "majority ownership interest" if it directly or indirectly holds a majority of the equity securities of an entity, or the right to receive upon dissolution, or the contribution of, a majority of the capital of a partnership." 17 C.F.R. § 50.52(a)(2)(i).

to be executed on a SEF or DCM would not promote the pre-trade price transparency and price discovery goals associated with the trade execution requirement because affiliate counterparties are not primarily concerned with obtaining fully competitive pricing.⁸ ISDA also notes that certain required execution methods—as prescribed by § 37.9 and subpart J of part 38 of the Commission’s regulations—would not accommodate swap transactions between affiliates. For example, ISDA states that executing such a transaction through an Order Book would not assure that the affiliates’ quotes will be matched with one another as intended. Accordingly, ISDA states that non-time-limited no-action relief from the trade execution requirement for inter-affiliate transactions is needed to preserve the purposes for executing such transactions and to avoid imposing unnecessary challenges.

Discussion

The Division acknowledges ISDA’s stated purposes for executing inter-affiliate transactions and its concerns regarding how eligible affiliate counterparties could execute swap transactions with one another in a manner compliant with the trade execution requirement, *e.g.*, through an Order Book, absent election of the inter-affiliate exemption from required clearing. Pursuant to § 37.9, affiliates that do not meet the conditions of the inter-affiliate exemption from required clearing, that wish to use a SEF to execute an inter-affiliate swap transaction involving a swap subject to the trade execution requirement, would be able to do so only through required methods of execution, *i.e.*, an Order Book or RFQ System. Similarly, affiliates that are unable to meet the conditions of the inter-affiliate exemption from required clearing, that wish to execute an inter-affiliate transaction on a DCM, would be subject to the general requirement of CEA section 5(d)(9). The Division, however, is also mindful of the mandate under the Dodd-Frank Act and the intent of the Commission’s implementing regulations to promote pre-trade price transparency in the swaps market.

The Division also acknowledges the policy goals of the conditions of the inter-affiliate exemption from required clearing.⁸ Further, the Division notes that all of the potential affiliate counterparties eligible for the relief from the trade execution requirement contained in this letter are eligible to use § 50.52 of the Commission’s regulations, should they elect to comply with the conditions of § 50.52. As noted above, swaps entered into by eligible affiliate counterparties that elect and comply with the conditions, among other things, of the inter-affiliate exemption would not be subject to the trade execution requirement.

Nevertheless, to balance the goals described above, the Division will provide temporary relief from the trade execution requirement to eligible affiliate counterparties, as defined in § 50.52(a) of the Commission’s regulations, that do not elect the inter-affiliate exemption from required clearing. During this period of relief, the Division will continue to evaluate, based on ongoing observations of inter-affiliate market activity occurring both on and off of SEFs and DCMs, whether such swap transactions should be subject to the trade execution requirement. In

⁸ *See, e.g.*, 7 U.S.C. § 7b-3(e) (stating that the goal of establishing SEFs is to, among other things, “promote pre-trade price transparency in the swaps market.”); 7 U.S.C. § 7(d)(9)(A) (requiring DCMs to provide a mechanism for executing transactions that “protects the price discovery process of trading. . .”)

particular, the Division will assess whether applying the trade execution requirement to inter-affiliate swap transactions would promote pre-trade price transparency in the swaps market. Moreover, the Division will continue to consider the implications of this relief on the policy goals of the conditions of the inter-affiliate exemption from required clearing.

Time-Limited No-Action Relief for Eligible Affiliate Counterparties from the Trade Execution Requirement

For the reasons described above, the Division will grant time-limited no-action relief from the requirements of CEA section 2(h)(8) to eligible affiliate counterparties, as defined in § 50.52(a) of the Commission's regulations, that transact swap transactions with one another that involve a swap subject to the trade execution requirement, until 11:59 p.m. (eastern time) December 31, 2014. The Division will grant the above time-limited no-action relief, and will not recommend that the Commission take enforcement action against any eligible affiliate counterparty that executes a swap transaction with another eligible affiliate counterparty without complying with CEA section 2(h)(8).

Market participants should be aware that the no-action positions taken herein do 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 reporting requirements and clearing requirements, including the requirements and conditions for eligible affiliate counterparties not to clear a swap pursuant to § 50.52 of the Commission's regulations or the requirements to clear a swap pursuant to §50.2 and §50.4 of the Commission's regulations.⁹ This letter, and the no-action positions taken herein, represent the views of the Division only, and do 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.

⁹ The applicable swap 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. Eligible affiliate counterparties that wish to avail themselves of the inter-affiliate clearing exemption must fulfill additional conditions and requirements set forth in § 50.52(b)-(d) of the Commission's regulations.

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, or Nhan Nguyen, Special Counsel, Division of Market Oversight, at (202) 418-5932 or nnguyen@cftc.gov.

Sincerely,

Vincent A. McGonagle
Director
Division of Market Oversight