



## U.S. COMMODITY FUTURES TRADING COMMISSION

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Division of Swap Dealer and  
Intermediary Oversight

Gary Barnett  
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CFTC Letter No. 13-12  
No-Action  
May 1, 2013  
Division of Swap Dealer and Intermediary Oversight

### **Re: Relief for Swap Dealers and Major Swap Participants Regarding the Obligation to Provide Certain Disclosures for Certain Transactions Under Regulation 23.431**

Ladies and Gentlemen:

This letter is in response to requests from the Foreign Exchange Committee (“FXC”), the Financial Markets Lawyers Group (“FMLG”), the Wholesale Markets Brokers Association (“WMBA”) and Thomson Reuters Corporation (“Thomson Reuters”) on behalf of FX Alliance, LLC and Reuters Transactions Services Limited (together, the “Requesting Parties”) to the Division of Swap Dealer and Intermediary Oversight (“Division”) of the Commodity Futures Trading Commission (“Commission”), in which the Requesting Parties requested relief from the Division that would permit swap dealers (“SDs”) and major swap participants (“MSPs”), under certain circumstances described herein, to enter into certain transactions without disclosing a pre-trade mid-market mark (the “PTM”) to the non-SD, non-MSP counterparties (the “counterparties”) to such transactions as required under Commission Regulation (“Regulation”) 23.431(a)(3)(i).<sup>1</sup>

#### **Applicable Regulatory Requirements**

Section 4s(h)(3)(B) of the CEA directs the Commission to adopt business conduct standards for SDs and MSPs that:

require disclosure by the swap dealer or major swap participant to any counterparty to the transaction (other than a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant) of –

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<sup>1</sup> Although FMLG and FXC are sponsored by the Federal Reserve Bank of New York, the letter requesting relief states that the request was not endorsed by the Federal Reserve Bank of New York or the Federal Reserve System.

(iii) (I) for cleared swaps, upon the request of the counterparty, receipt of the daily mark of the transaction from the appropriate derivatives clearing organization; and (II) for uncleared swaps, receipt of the daily mark of the transaction from the swap dealer or the major swap participant.<sup>2</sup>

On February 17, 2012, the Commission issued final rules pursuant to 4s(h) of the CEA prescribing certain business conduct standards for SDs and MSPs, which included Regulation 23.431.<sup>3</sup> In relevant part, Regulation 23.431 reads as follows:

At a reasonably sufficient time prior to entering into a swap, a swap dealer or major swap participant shall disclose to any counterparty to the swap (other than a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant) material information concerning the swap in a manner reasonably designed to allow the counterparty to assess . . . [t]he material incentives and conflicts of interest that the swap dealer or major swap participant may have in connection with a particular swap, which shall include: (i) [w]ith respect to disclosure of the price of the swap, the price of the swap and the mid-market mark of the swap as set forth in paragraph (d)(2) of this section . . . .<sup>4</sup>

The initial compliance date for § 23.431 was the later of 180 days after the effective date of the publication of the final rule or “the date on which swap dealers or major swap participants are required to apply for registration pursuant to Commission rule 3.10.”<sup>5</sup> The Commission subsequently postponed the compliance date for a number of the business conduct standards rules, including § 23.431, until May 1, 2013.<sup>6</sup>

In describing the purpose of requiring SDs and MSPs to disclose the PTM, the Commission stated that “the spread between the quote and mid-market mark is relevant to disclosures regarding material incentives and provides the counterparty with pricing information

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<sup>2</sup> CEA Section 4s(h)(3)(B), 7 U.S.C. § 6s(h)(3)(B).

<sup>3</sup> Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties, 77 Fed. Reg. 9734 (Feb. 17, 2012) (hereinafter “Final Business Conduct Standards”). In the proposed business conduct standards rules, the Commission proposed Regulation 23.431 to “provide specificity with respect to certain material information that must be disclosed” by swap dealers and major swap participants. Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties, 75 Fed. Reg. 80638, 80643 (proposed Dec. 22, 2010).

<sup>4</sup> Final Business Conduct Standards at 9824.

<sup>5</sup> External Business Conduct Standards at 9734.

<sup>6</sup> In September 2012, the Commission changed the compliance date of §§ 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 to January 1, 2013. *See* Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 77 FR 55904, 55942 (Sept. 11, 2012). The Commission later changed the compliance date for these provisions to May 1, 2013. *See* Business Conduct and Documentation Requirements for Swap Dealers and Major Swap Participants; Extension of Compliance Date, 78 FR 17, 20 (Jan. 2, 2013).

that facilitates negotiations and balances historical information asymmetry regarding swap pricing.”<sup>7</sup>

However, Regulation 23.431(c) provides an exception from the requirement for an SD or MSP to provide the PTM. It states that the requirement to provide a PTM does not apply with respect to a transaction that is “(1) [i]nitiating on a designated contract market or a swap execution facility; and (2) [o]ne in which the swap dealer or major swap participant does not know the identity of the counterparty to the transaction prior to execution.”<sup>8</sup>

The Division notes that pursuant to Section 1a(47)(E) of the Commodity Exchange Act (“CEA”),<sup>9</sup> the Secretary of the Treasury (“Secretary”) is vested with the authority to determine whether foreign exchange swaps and forwards<sup>10</sup> should be regulated as swaps under the CEA, provided that the Secretary makes a written determination satisfying certain criteria specified in CEA Section 1b. On November 16, 2012, the Secretary issued a written determination that physically-settled foreign exchange forwards and swap agreements should not be regulated as swaps under the CEA (“Treasury Determination”).<sup>11</sup> Nonetheless, CEA Section 1a(47)(E)(iv) states that, notwithstanding the Secretary’s written determination, “any party to [an Exempt FX Transaction<sup>12</sup>] that is a SD or MSP shall conform to the business conduct standards contained in section 4s(h).”<sup>13</sup> Thus, SDs and MSPs are required to comply with the business conduct standards adopted by the Commission in subpart H of part 23 of the Commission’s regulations by May 1, 2013, including § 23.431.

### **Previous No-Action Relief**

In Staff Letter No. 12-42 (Dec. 6, 2012), the Division granted no-action relief from the PTM requirement for limited types of foreign exchange transactions. Specifically, the Division stated that it would not recommend that the Commission take an enforcement action against an SD or MSP for failure to disclose the PTM, as required by Regulation 23.431(a)(3), to a

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<sup>7</sup> *Id.* at 9766. In the preamble to the proposed rule, the Commission noted that the “mid-market [mark] is a transparent measure that would assist counterparties in calculating valuations for their own internal risk management purposes.” Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties, 75 Fed. Reg. 80638, 80646 (proposed Dec. 22, 2010).

<sup>8</sup> Final Business Conduct Standards at 9824.

<sup>9</sup> 7 U.S.C. 1a(47)(E).

<sup>10</sup> Foreign exchange swaps and foreign exchange forwards are defined in Sections 1a(24) and 1a(25), respectively, of the Commodity Exchange Act.

<sup>11</sup> Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 77 Fed. Reg. 69694 (Nov. 20, 2012) (hereinafter, the “Treasury Determination”).

<sup>12</sup> Physically-settled foreign exchange forwards and swap agreements that have been exempted from the definition of swap by the U.S. Department of the Treasury are hereinafter referred to as “Exempt FX Transactions.” *See* Treasury Determination.

<sup>13</sup> Additionally, foreign exchange swaps and forwards are subject to reporting obligations, pursuant to Section 1a(47)(E)(iii) of the CEA, 7 U.S.C. § 1a(47)(E)(iii).

counterparty in connection with: (a) foreign exchange swaps and forwards that, by their terms, are physically settled, where each currency is one that is included among the top 13 deliverable currencies (by volume) described in the Bank for International Settlements' Triennial Central Bank Survey, Report on Global Foreign Exchange Market Activity in 2010 (the "BIS 13 Currencies"),<sup>14</sup> and where the transaction has a stated maturity of one year or less; and (b) vanilla foreign exchange options that, by their terms, are physically settled, where each currency is one included among the BIS 13 Currencies, and where the option has a stated maturity of six months or less, provided that: (1) real-time tradable bid and offer prices for the applicable transactions were available electronically in the marketplace to the counterparty; and (2) the counterparty to the applicable transaction agreed in advance, in writing, that the SD or MSP need not disclose a PTM.

The Division granted the no-action relief based on, among other things, representations made by FXC and FMLG that the applicable transactions benefit from a combination of high liquidity, narrow bid and offer spreads, and the existence of a significant amount of publicly available information with respect thereto, arguing therefore that compliance with the PTM requirement does not provide any significant additional informational value but would require SDs and MSPs to create a new price stream when quotes are provided electronically and would add additional operational requirements for dealers when quotes are conveyed by voice. With their original request for relief, FXC and FMLG submitted data collected from foreign exchange dealers and public sources showing that the PTM that would be disclosed by SDs and MSPs in connection with the applicable transactions would be substantially similar to publicly available information.<sup>15</sup> In the letter granting no-action relief, the Division stated that it would consider extending the no-action relief to other transactions, if sufficient data and other relevant information were submitted to the Division establishing the appropriateness of an extension.

### **Summary of Additional Requests for Relief**

Subsequent to the Division's grant of no-action relief, FXC and FMLG submitted a letter requesting that the Division expand the transactional scope of the no-action relief granted in Staff Letter No. 12-42 to include: (i) foreign exchange forwards or swaps, and transactions that would be foreign exchange forwards or swaps but for the fact that they are non-deliverable, in each case where each currency is one included among the top 31 currencies (by volume) described in the Bank for International Settlements' Triennial Central Bank Survey Report on global foreign

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<sup>14</sup> The BIS 13 Currencies referenced in Staff Letter 12-42 excluded the Korean won, which is a restricted currency. Excluding the Korean won, the top thirteen deliverable currencies by volume are the US dollar, Euro, Japanese yen, Pound sterling, Australian dollar, Swiss franc, Canadian dollar, Hong Kong dollar, Swedish krona, New Zealand dollar, Singapore dollar, Norwegian krone and Mexican peso. See Bank for International Settlements, 2010 BIS Triennial Central Bank Survey, Report on global foreign exchange market activity in 2010 12 (Dec. 2010), available at <http://www.bis.org/publ/rpfx10t.pdf>.

<sup>15</sup> In data submitted by the FXC and FMLG that was collected from major foreign exchange dealers and Bloomberg, "the typical deviation from a publicly available mid (as provided by Bloomberg) is just \$36 on a \$1m notional EUR/USD forward deal, \$77 on a \$1m notional AUD/USD forward deal and \$254 on a \$1m notional USD/MXN forward deal." Letter from FXC and FMLG to Gary Barnett at A-1 (Nov. 16, 2012).

exchange market activity in 2010 (“BIS 31 Currencies”)<sup>16</sup> and the transaction has a stated maturity of two years or less, (ii) vanilla foreign exchange options whether deliverable or non-deliverable, where each currency is one included among the BIS 31 Currencies and the option has a stated maturity of two years or less, and (iii) multi-component transactions comprised entirely of a combination and/or series of the foregoing transactions. As part of their request, FXC and FMLG submitted data collected from foreign exchange dealers and public sources that they believe shows that the PTM that would be disclosed by SDs and MSPs in connection with the above referenced transactions would be substantially similar to publicly available information. Therefore, they argue that the additional information that would be provided by the PTM would be minimal.

In a separate letter, Thomson Reuters requested relief from the requirement to provide the PTM for certain transactions executed on anonymous electronic trading platforms.<sup>17</sup> Thomson Reuters notes that Commission regulation § 23.431(c) provides that an SD or MSP need not disclose the PTM with respect to a swap if the swap is (1) initiated on a DCM or SEF and (2) the SD or MSP does not know the identity of the counterparty prior to execution. However, Exempt FX Transactions are not required to be executed on SEFs or DCMs and may be executed on an electronic trading platform that is not registered as a SEF or DCM. Thomson Reuters notes that an SD or MSP that executes an Exempt FX Transaction on an electronic trading platform that is not registered as a SEF or DCM will not be able to rely on § 23.431(c) for an exception to the PTM disclosure requirement. This would be true even if the SD or MSP were matched anonymously to the counterparty on the electronic trading platform and if real-time, pre-trade pricing information was available to the counterparty prior to entering into the transaction.

Thomson Reuters argues that the pre-trade pricing information that is available on many electronic trading platforms not registered as a SEF or DCM is not materially different than the information that would be conveyed by disclosure of the PTM by individual SDs and MSPs. Additionally, they argue that requiring disclosure would impose substantial additional costs that would likely lead to a decrease in market liquidity and transparency due to decreased participation on anonymous electronic trading platforms.

Therefore, Thomson Reuters requested that the Division provide no-action relief for SDs and MSPs from the requirement to provide the PTM for certain foreign exchange swaps and forwards, executed on a non-SEF, non-DCM anonymous electronic trading platform where: (1) contracts executed on the electronic trading platform are Exempt FX Transactions, (2) only eligible contract participants participate in the non-SEF, non-DCM anonymous electronic trading

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<sup>16</sup> The BIS 31 Currencies referenced in FXC and FMLG’s request are composed of the following: US dollar, Euro, Japanese yen, Pound sterling, Australian dollar, Swiss franc, Canadian dollar, Hong Kong dollar, Swedish krona, New Zealand dollar, Korean won, Singapore dollar, Norwegian krona, Mexican peso, Indian rupee, Russian rouble, Chinese renminbi, Polish zloty, Turkish lira, South African rand, Brazilian real, Danish krone, New Taiwan dollar, Hungarian forint, Malaysian ringgit, Thai baht, Czech koruna, Philippine peso, Chilean peso, Indonesian rupiah, Israeli new shekel. See Bank for International Settlements, *supra* note 11, at 12.

<sup>17</sup> For purposes of this letter, the term “electronic trading platform” means the platform on which the transactions are executed.

platform, (3) counterparties are automatically and anonymously matched and no price negotiations occur for the transactions executed on these platforms, and (4) the non-SEF, non-DCM anonymous electronic trading platform will maintain an audit trail and, upon request, will provide to the Commission books and records to enable the Commission to reconstruct the trades. WMBA requested similar relief for all types of transactions subject to the Commission's business conduct standards rules that are executed under circumstances where the SD or MSP does not know the identity of the counterparty prior to execution.

### **Division No-Action Position**

Based on the representations of the Requesting Parties and informed by discussions with other market participants, the Division believes that relief is warranted under certain circumstances and under certain conditions. Accordingly, the Division will not recommend that the Commission commence an enforcement action against an SD or MSP for failure to disclose the PTM to a counterparty in a transaction, as required by Regulation 23.431(a)(3)(i), subject to the following conditions:

- (a) The transaction is (1) a foreign exchange swap or forward that, by its terms, is physically settled, where each currency is one of the BIS 31 Currencies and where the transaction has a stated maturity of one year or less, or (2) a vanilla foreign exchange option that, by its terms, is physically settled, where each currency is one included among the BIS 31 Currencies, and where the option has a stated maturity of six months or less;<sup>18</sup>
- (b) Real-time tradeable bid and offer prices for the transaction are available electronically, in the marketplace, to the counterparty; and
- (c) The counterparty to the transaction agrees in advance, in writing, that the SD and MSP need not disclose a PTM.

In addition, the Division will not recommend that the Commission commence an enforcement action against an SD or MSP for failure to comply with Regulations 23.431(a) and (b), in connection with an Exempt FX Transaction, subject to the following conditions:

- (a) The Exempt FX Transaction is initiated on an electronic trading platform and the SD or MSP does not know the identity of the counterparty prior to execution, whether or not the platform is a SEF or DCM;
- (b) Only eligible contract participants participate in the anonymous electronic trading platform; and

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<sup>18</sup> The Division notes that the transactions for which it is granting no-action relief does not cover all transactions for which relief was requested by FXC and FMLG. While it will continue to assess whether to grant additional relief, at this time the Division is only expanding the relief that was granted in Staff Letter 12-42 (Dec. 6, 2012) to cover additional currencies, as described in this letter.

- (c) Real-time tradeable bid and offer prices for the Exempt FX Transaction are available electronically, in the marketplace, to the counterparty.

The Division is applying this no-action relief based on, among other things, the representations of the Requesting Parties that real-time tradable bid and offer prices are available in the marketplace and that counterparties benefit from a combination of high liquidity, narrow bid and offer spreads, and the existence of a significant amount of publicly available information. The Division will continue to monitor market data with respect to the liquidity, bid and offer spreads, and publicly available information for the transactions subject to relief under this letter, and if the circumstances change, the Division may limit, impose additional or different conditions on, or revoke this no-action relief. The Division also notes that this no-action relief does not affect any obligation to provide a daily mark pursuant to Regulation 23.431(d), nor any obligation to report a transaction or information concerning a transaction under part 43 or part 45 of the Commission's regulations.

This letter, and the positions taken herein, represent the view of this Division only, and do not necessarily represent the position or view of the Commission or of any other office or division of the Commission. In particular, notwithstanding the description of any foreign exchange agreement, contract, or transaction herein, nothing in this letter is intended to address, expand, interpret, or modify the definitions of foreign exchange swaps or foreign exchange forwards in Sections 1a(24) and 1a(25), respectively, of the Commodity Exchange Act. The relief issued by this letter does not excuse persons relying on it from compliance with any other applicable requirements contained in the Act or in the Regulations issued thereunder. Further, this letter, and the relief contained herein, is based upon the representations made to the Division. Any different, changed or omitted material facts or circumstances might render this no-action relief void.

Should you have any questions, please do not hesitate to contact me at (202) 418-5977; Ward Griffin, Associate Chief Counsel, at (202) 418-5425; or Adam Kezsbom, Special Counsel, at (202) 418-5372.

Very truly yours,

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