U.S. COMMODITY FUTURES TRADING COMMISSION
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Division of Clearing and Risk
Division of Market Oversight

John McKinlay
Director, Assistant General Counsel
CME Group
20 South Wacker Drive
Chicago, IL 60606

Re: Request for Interpretation Regarding the Applicability of Sections 2(h)(1) and 2(h)(8) of the Commodity Exchange Act and Related Commission Regulations to Swap Transactions Executed in Connection with Default Management Processes

Dear Mr. McKinlay:

This letter responds to CME Group's ("CME") request for an interpretation by the Division of Clearing and Risk and the Division of Market Oversight (collectively, the "Divisions") regarding Sections 2(h)(1)[1] and 2(h)(8)[2] of the Commodity Exchange Act (the "CEA") and Commodity Futures Trading Commission (the "Commission") regulations thereunder. By letter dated July 30, 2020, CME requested an interpretation addressing whether "Default Management Transactions," as defined below, are subject to the clearing or trade execution requirements set forth in Sections 2(h)(1) and 2(h)(8) of the CEA, respectively.

Background

Clearing and Trade Execution Requirements

Section 2(h)(1)(A) of the CEA prohibits a person from engaging in a swap that is required to be cleared unless that person submits such swap for clearing to a derivatives clearing organization ("DCO") that is either registered or exempt from registration under the CEA (the "Clearing Requirement"). Regulation 50.4[3] enumerates classes of swaps that are required to be cleared.

[1] 7 U.S.C. § 2(h)(1).

[2] 7 U.S.C. § 2(h)(8).

[3] 17 C.F.R. § 50.4.

Section 2(h)(8) of the CEA requires that swap transactions that are subject to the clearing requirement must be executed on a designated contract market or a swap execution facility that is either registered or exempt from registration under the CEA, unless no such entities make the swap available for trade or the relevant swap transaction is subject to the clearing exception under CEA Section 2(h)(7)[4] (the "Trade Execution Requirement").

Default Management

Commission regulations require a registered DCO to use risk control mechanisms to "limit [the DCO's] exposure to potential losses from defaults by its clearing members."[5] In particular, a DCO is required to adopt rules detailing the actions it may take upon a default, "which shall include the prompt transfer, liquidation, or hedging of the customer or house positions of the defaulting clearing member."[6]

CME has rules permitting it to enter into swaps transactions, including hedges, liquidations, offsets, porting, and similar such transactions, whether by auction, sale, book-entry or other means, to reduce and manage the risk associated with a clearing member default ("Default Management Transactions"). The instruments and processes used to manage a particular default are determined by CME's rules, the circumstances at the time of default, and the composition of the defaulted clearing member's portfolio.

According to CME's representations, Default Management Transactions are conducted with a willing counterparty for the purpose of flattening or mitigating market risk in furtherance of CME's risk management functions. Default Management Transactions are not entered into by two third parties and subsequently cleared by CME, nor are they a direct result of the novation of a swap submitted to CME for clearing. Because Default Management Transactions may include classes of swaps that are required to be cleared under Regulation 50.4, they potentially implicate the Clearing and Trade Execution Requirements.

Discussion

The Divisions have previously interpreted Section 2(h)(1) to not require the clearing of certain swaps that originate with a DCO. In CFTC Letter No. 15-51,[7] the Divisions considered swaps resulting from a "firm or forced trades" process, in which a DCO requires its clearing members to submit bid and ask prices for certain swaps, and then, under certain conditions, requires a clearing member to buy or sell a swap at a price based on the clearing member's

[4] 7 U.S.C. § 2(h)(7).

[5] 17 C.F.R. § 39.13(f); *see also* 17 C.F.R. § 39.16(c)(1) (a DCO "shall adopt procedures that would permit [it] to take timely action to contain losses and liquidity pressures and to continue meeting its obligations in the event of a default on the obligations of a clearing member to the [DCO]").

[6] 17 C.F.R. § 39.16(c)(2)(ii).

[7] CFTC Letter No. 15-51 (Sept. 18, 2015) available at https://www.cftc.gov/node/213981.

submitted price. This process, which results in the creation of a new swap between the DCO and its clearing member, is a price discovery mechanism allowing a DCO to pay or collect the appropriate amount of variation margin, as required by Commission regulations, for certain swaps for which pricing data may not be readily available or reliable. The Divisions noted that "the fact that the DCO itself is a counterparty to the swap means that the swap cannot be submitted to the DCO for clearing," and that as a result, "such swaps cannot logically be subject to the [C]learing [R]equirement."

Similar logic applies with respect to Default Management Transactions. Here, a DCO enters into swaps transactions to flatten or mitigate the risks it faces following a clearing member default. Regardless of the specific type of Default Management Transaction at issue, the transaction is initiated by the DCO, which guarantees performance in its capacity as such. Because the DCO is a counterparty to the swap upon inception and immediately guarantees performance, the swap cannot be subsequently submitted to the DCO for clearing. Therefore, as with the firm or forced trades addressed in CFTC Letter No. 15-51, such swaps cannot logically be subject to the Clearing Requirement. Because the Trade Execution Requirement only applies to swaps subject to the Clearing Requirement, it therefore is also inapplicable.

Conclusion

Accordingly, based on the facts presented by CME and its representations to the Divisions as discussed above, the Divisions do not interpret Sections 2(h)(1) and 2(h)(8) of the CEA as subjecting Default Management Transactions to the Clearing and Trade Execution Requirements.

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. Any different, changed, or omitted material facts or circumstances may require a different conclusion or render this letter void. As with all interpretative letters, the Divisions retain the authority to condition further, modify, suspend, terminate, or otherwise restrict the interpretation provided herein, in its discretion. Should you have questions regarding this matter, please contact Brian Baum, Special Counsel, Division of Clearing and Risk (bbaum@cftc.gov, 202-418-5654), Theodore Polley, Associate Director, Division of Clearing and Risk (tpolley@cftc.gov, 312-596-0551), or Roger Smith, Associate Chief Counsel, Division of Market Oversight (rsmith@cftc.gov, 202-418-5344).

Sincerely,

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