



U.S. COMMODITY FUTURES TRADING COMMISSION

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Division of Market Oversight

September 30, 2013

To: All CFTC Registered Swap Execution Facilities and Applicants for Registration as a Swap Execution Facility

Division of Market Oversight Guidance on Application of Certain Commission Regulations to Swap Execution Facilities

The Division of Market Oversight (the “Division”) of the Commodity Futures Trading Commission (the “Commission”) is issuing this guidance (“Guidance”) to remind swap execution facilities (“SEFs”) of the substance of certain Commission regulations. It has come to the Division’s attention that some SEF rulebooks contain provisions which appear to be inconsistent with the Commission’s regulations.¹ Specifically, this Guidance addresses: (1) the definition of “member” in the swap execution facility final rulemaking (the “SEF Final Rulemaking”),² (2) the exception to the aggregation prohibition in order to satisfy the minimum block trade size or cap size requirement in Commission regulation 43.6(h)(6),³ (3) the liquidation or transfer of open positions in any contract and the imposition of margin requirements in emergency situations under Commission regulation 37.801,⁴ (4) the reporting of block trade data to swap data repositories (“SDRs”) under Commission regulation 43.6(g),⁵ and (5) the time delay requirement under Commission regulation 37.9(b).⁶

I. Definition of Member

The Division notes that some SEF rulebooks define “member” in an unclear or overly expansive manner. This lack of clarity is significant as “membership” carries, among other

¹ The Division notes that it did not undertake a substantive review of the SEFs’ rulebooks during the temporary registration process. However, to the extent that the Division is aware that SEFs have rules which are inconsistent with the Commission’s regulations, the Division believes it is incumbent to reiterate the substance of those regulations.

² Core Principles and Other Requirements for Swap Execution Facilities, 78 FR 33476 (Jun. 4, 2013).

³ Commission regulation 43.6(h)(6).

⁴ Commission regulation 37.801 and the applicable guidance in Appendix B to part 37.

⁵ Commission regulation 43.6(g).

⁶ Commission regulation 37.9(b).

things, liability and regulatory responsibilities.⁷ In this regard, the Division notes that the SEF Final Rulemaking stated that “member” has the meaning set forth in section 1a(34) of the Commodity Exchange Act (“CEA”).⁸ Section 1a(34) provides that the term “member” means, with respect to a registered entity⁹ ... “an individual, association, partnership, corporation, or trust – (A) owning or holding membership in, or admitted to membership representation on, the registered entity ... or (B) having trading privileges on the registered entity”¹⁰ The Division notes that “trading privileges,” in section 1a(34) in the SEF context, is generally understood to mean the rights granted to a person by a SEF to directly, or through an independent software vendor,¹¹ effect transactions on the SEF. The Division does not believe that the term “member” means a client/customer of a trading privilege holder that has neither a membership interest in a SEF nor any direct access trading privileges to a SEF’s trading platform. The Division reminds SEFs that persons or entities that do not fall within the scope of CEA section 1a(34) should not be considered members of the SEF and subject to the SEF rules applicable to members.

II. Exception to Aggregation Prohibition

The Division has also learned that certain SEFs prohibit investment and/or trading advisors from aggregating orders for different accounts to satisfy their block trade minimum requirements, notwithstanding that section 43.6(h)(6) of the Commission’s regulations would permit such aggregation.¹² The Division reminds SEFs that they should include such exceptions in their rulebooks.

III. Liquidation or Transfer of Open Positions and Margin Requirements

It has also come to the Division’s attention that some SEF rulebooks grant the SEF rights to impose certain requirements on participants, such as rights related to liquidation and/or transfer and additional margin. The Division notes that the statute in Core Principle 8 requires a

⁷ For example, members have recordkeeping obligations under § 37.203(b) and are subject to a SEF’s annual reviews of its audit trail and recordkeeping requirements under § 37.205(c)(1).

⁸ 78 FR 33506.

⁹ Registered entity is defined in CEA section 1a(40) to include a SEF. 7 U.S.C. 1a(40).

¹⁰ CEA section 1a(34); 7 U.S.C. 1a(34).

¹¹ See 78 FR at 33508 n. 423 for examples of independent software vendors.

¹² Specifically, section 43.6(h)(6) of the Commission’s regulations provides that the aggregation of orders for different accounts in order to satisfy the minimum block trade size or the cap size requirement is prohibited, except it is permissible if done by a person who “(i)(A) Is a commodity trading advisor registered pursuant to Section 4n of the Act, or exempt from registration under the Act, or a principle thereof, who has discretionary trading authority or directs client accounts, (B) Is an investment adviser who has discretionary trading authority or directs client accounts and satisfies the criteria of § 4.7(a)(2)(v) of this chapter or (C) Is a foreign person who performs a similar role or function as the persons described in paragraphs (h)(6)(i)(A) or (h)(6)(i)(B) of this section and is subject as such to foreign regulation; and (ii) Has more than \$25,000,000 in total assets under management.” Commission regulation 43.6(h)(6).

SEF to adopt rules to provide for the exercise of emergency authority, in consultation or cooperation with the Commission, as is necessary and appropriate, including the authority to liquidate or transfer open positions in any swap or to suspend or curtail trading in a swap (emphasis added).¹³ The guidance to Core Principle 8 states that to address perceived market threats, a SEF should have rules that allow it to take emergency actions to, among other things, impose special margin requirements or order the liquidation or transfer of open positions in any contract.¹⁴ The Division notes that the guidance to Core Principle 8 is intended to apply only to emergencies as defined in section 40.1(h) of the Commission's regulations – not to normal business operations.¹⁵ A SEF's exercise of such emergency action must be carried out pursuant to Core Principle 8 and part 40 of the Commission's regulations.¹⁶ Part 40 requires that rules or rule amendments implemented to respond to an emergency be filed with the Commission prior to implementation, if practicable, and if not, within twenty-four hours after implementation.¹⁷ Thus, any emergency actions by a SEF to impose special margin or other requirements must be filed as a rule.

IV. Block Trade Reporting

The Division has also learned that certain SEFs may not report swap transaction data for block trades executed pursuant to the rules of a SEF to a registered SDR. The Division reminds SEFs that they are obligated to report such data for block trades (as defined below) to a registered swap data repository pursuant to Commission regulation 43.6(g).¹⁸ The Division notes that “block trade” is defined in Commission regulation 43.2, as a “publicly reportable swap transaction that: (1) Involves a swap that is listed on a registered [SEF] or [DCM]; (2) Occurs away from the registered [SEF's] or [DCM's] trading system or platform and is executed pursuant to the registered [SEF's] or [DCM's] rules and procedures; (3) Has a notional or principal amount at or above the appropriate minimum block size applicable to such swap; and (4) Is reported subject to the rules and procedures of the registered [SEF] or [DCM] and the rules described in [part 43]”¹⁹ In addition, the Division notes that Commission regulation 43.6(g) requires that when the counterparties to a block trade notify the SEF of the election to have the publicly reportable swap transaction treated as a block trade, the SEF must notify the SDR of such block trade election when transmitting swap transaction and pricing data to the SDR in

¹³ CEA section 5h(f)(8); 7 U.S.C. 7b-3(f)(8). In the SEF Final Rulemaking, regulation 37.801 provides that a SEF may reference the guidance in appendix B to part 37 to demonstrate compliance with the requirements of Core Principle 8. Commission regulation 37.801.

¹⁴ Guidance to Core Principle 8 in Appendix B to part 37.

¹⁵ See Commission regulation 40.1(h) for the definition of emergency.

¹⁶ See Commission regulation 40.6(a)(6).

¹⁷ Id.

¹⁸ Commission regulation 43.6(g).

¹⁹ Commission regulation 43.2.

accordance with section 43.3(b)(1).²⁰ The Division further notes that SEFs have corollary regulatory obligations under part 45 for swaps that are executed on, or pursuant to, the rules of a SEF.

V. Time Delay Requirement

The Division has further learned that some SEF rulebooks expand the scope of the time delay requirement under Commission regulation 37.9(b) to situations where there is no form of pre-arrangement or pre-negotiation. The Division reminds SEFs that the time delay requirement under Commission regulation 37.9(b) applies when there is some form of pre-arrangement, pre-negotiation, or pre-execution communications. The Division notes that the time delay requirement states that a SEF must require that “a broker or dealer who seeks to either execute against its customer’s order or execute two of its customers’ orders against each other through the [SEF’s] Order Book, following some form of pre-arrangement or pre-negotiation of such orders, be subject to at least a 15 second time delay between the entry of those two orders into the Order Book, such that one side of the potential transaction is disclosed and made available to other market participants before the second side of the potential transaction, whether for the broker’s or dealer’s own account or for a second customer, is submitted for execution.”²¹ The Division also notes that a SEF that allows pre-execution communications must adopt rules regarding such communications, and orders that result from pre-execution communications would also be subject to the time delay requirement.²²

Finally, the Division reminds SEFs that they may make changes to their rulebooks at any time, pursuant to either the certification or approval procedures set forth in part 40 of the Commission’s regulations, provided that such rule changes are not inconsistent with the Act or the Commission’s regulations.

This Guidance supersedes any previous guidance issued by the Division on these topics. This Guidance, and the positions taken herein, represent the views of the Division only, and do not necessarily represent the views of the Commission or of any other office or division of the Commission. If you have any questions concerning this Guidance, please contact Nancy Markowitz, Deputy Director, Division of Market Oversight, at (202) 418-5453 or nmarkowitz@cftc.gov, or Amir Zaidi, Special Counsel, Division of Market Oversight, at (202) 418-6770 or azaidi@cftc.gov.

²⁰ Commission regulation 43.6(g).

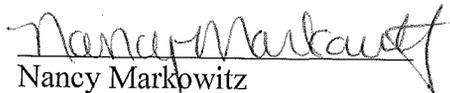
²¹ Commission regulation 37.9(b)(1).

²² 78 FR at 33503.

Sincerely,

A handwritten signature in black ink, appearing to read "David P. Van Wagner", written over a horizontal line.

David P. Van Wagner
Chief Counsel
Division of Market Oversight

A handwritten signature in black ink, appearing to read "Nancy Markowitz", written over a horizontal line.

Nancy Markowitz
Deputy Director
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