



U.S. COMMODITY FUTURES TRADING COMMISSION

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CFTC Letter 15-24
No-Action
April 22, 2015
Division of Market Oversight
Division of Clearing and Risk

Re: No-Action Relief for Swap Execution Facilities and Designated Contract Markets in Connection with Swaps with Operational or Clerical Errors Executed on a Swap Execution Facility or Designated Contract Market

Ladies and Gentlemen:

This letter responds to a request received by the Division of Market Oversight and the Division of Clearing and Risk (together, the “Divisions”) of the Commodity Futures Trading Commission (the “Commission”) from the Wholesale Markets Brokers’ Association, Americas (“WMBAA”)¹ for no-action relief for swap execution facilities (“SEFs”) from certain of the requirements under Commission Regulations 37.9(a)(2) and 37.203(a)² to enable SEFs to correct clerical or operational errors of swaps that have been rejected for clearing and separately to correct operational or clerical errors identified after clearing.³ The no-action relief, which applies to SEFs and designated contract markets (“DCMs”),⁴ shall commence on the date of issuance of this letter and shall expire at 11:59 p.m. (Eastern Time) June 15, 2016.

Background

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”)⁵ amended the Commodity Exchange Act (“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 or pursuant to the rules of a DCM or SEF, unless no DCM or SEF

¹ WMBAA is an independent industry body that represents BGC Derivatives Markets, L.P., GFI Swaps Exchange LLC, ICAP SEF (US) LLC, ICAP Global Derivatives LTD, tpSEF, Inc., and Tradition SEF, Inc. Each of the WMBAA member firms is temporarily registered with the Commission as a swap execution facility.

² See 17 C.F.R. §§ 37.9(a)(2) and 37.203(a).

³ Staff construes operational or clerical errors to mean any type of error. Transactions that are rejected from clearing for credit reasons are not covered by this relief.

⁴ Consistent with the Divisions’ previous action in No-Action Letter 14-50 (April 18, 2014), this no-action letter also extends the relief provided herein to DCMs from the requirements under Commission Regulations 38.152 and 38.500. See 17 C.F.R. §§ 38.152 and 38.500.

⁵ Pub. L. 111-203, 124 Stat. 1376 (2010).

makes such swaps available to trade or such swaps qualify for the clearing exception under CEA section 2(h)(7) (the “trade execution requirement”).⁶

On June 4, 2013, the Commission published regulations governing SEFs.⁷ Under Commission Regulation 37.9(a)(2), a swap that is subject to the trade execution requirement (referred to as a “Required Transaction”) and is not a block trade, as defined under Commission Regulation 43.2,⁸ shall be executed on a SEF through either (1) an Order Book, as defined in Commission Regulation 37.3(a)(3)⁹ or (2) a Request for Quote System, as defined in Commission Regulation 37.9(a)(3),¹⁰ that operates in conjunction with an Order Book. Commission Regulation 37.203(a) requires that a SEF prohibit certain abusive trading practices, including pre-arranged trading (except for block trades or other types of transactions certified to or approved by the Commission, pursuant to Part 40 of the Commission’s regulations).

On April 9, 2012, the Commission published regulations governing DCMs that impose similar requirements.¹¹ Under Commission Regulation 38.152, a DCM must prohibit abusive trading practices on its markets by members and market participants including, among other things, pre-arranged trading. Commission Regulation 38.500 requires, with limited exceptions, that trades on a DCM be competitively executed as it requires a DCM to provide a competitive, open and efficient market and a mechanism for executing transactions that protects the price discovery process of trading in the centralized market.

On April 9, 2012, the Commission also published regulations governing the clearing of swaps, including the timing of acceptance for clearing.¹² Commission Regulations 1.74, 23.610 and 39.12(b)(7)¹³ set forth time frames for futures commission merchants (“FCMs”), swap dealers (“SDs”), major swap participants (“MSPs”) and derivatives clearing organizations (“DCOs”), respectively, to accept or reject a trade for clearing.¹⁴ These regulations require that a trade be submitted and accepted or rejected for clearing as quickly as would be technologically practicable as if fully automated systems were used.

Finally, on September 26, 2013, the Divisions issued Staff Guidance on Swaps Straight-Through Processing (“Staff Guidance”). The Staff Guidance stated, among other things, that: (a)

⁶ 7 U.S.C. § 2(h)(8).

⁷ Core Principles and Other Requirements for Swap Execution Facilities, 78 Fed. Reg. 33,476 (June 4, 2013).

⁸ See 17 C.F.R. § 43.2.

⁹ See 17 C.F.R. § 37.3(a)(3).

¹⁰ See 17 C.F.R. § 37.9(a)(3).

¹¹ Core Principles and Other Requirements for Designated Contract Markets, 77 Fed. Reg. 33,612 (June 19, 2012).

¹² See Customer Clearing Documentation, Timing of Acceptance for Clearing, and Clearing Member Risk Management, 77 Fed. Reg. 21,278 (Apr. 9, 2012).

¹³ See 17 C.F.R. §§ 1.74, 23.610, and 39.12(b)(7), respectively.

¹⁴ See *id.* at 21,285.

FCMs must screen orders for execution on a SEF pursuant to either Commission Regulations 1.73(a)(2)(i) or (ii), regardless of the method of execution;¹⁵ (b) pursuant to Commission Regulation 37.702(b), each SEF must make it possible for clearing FCMs to screen as required by Regulation 1.73 on an *order-by-order basis*;¹⁶ (c) SEFs must have rules stating that trades that are rejected from clearing are *void ab initio*;¹⁷ and (d) SEFs, FCMs, SDs and MSPs may not require breakage agreements as a condition for trading swaps intended for clearing on a SEF.¹⁸

After issuing the Staff Guidance, the Divisions were informed by market participants that some swap trades are rejected by a DCO because of operational or clerical errors that are readily correctable. For example, some clearing submissions fail to match on a material economic term due to an operational error; the trades are then rejected from clearing and deemed *void ab initio*. In response, on October 25, 2013, the Divisions issued No-Action Letter 13-66 providing time limited relief from Commission Regulation 37.9(a)(2), regarding methods of execution for required transactions, and Regulation 37.203(a), prohibiting pre-arranged trading, if, after a trade has been rejected for clearing, a SEF permits a new trade between the original parties, with terms and conditions that match the terms and conditions of the original trade, other than any such error and the time of execution, to be submitted for clearing without having been executed pursuant to the methods set forth in Regulation 37.9(a)(2).¹⁹ On April 18, 2014, the Commission provided similar relief to DCMs until June 30, 2014.²⁰ Both letters expired on June 30, 2014.

Market participants also informed the Divisions that issues could arise because DCOs clear package transactions on a leg-by-leg basis rather than clearing all legs simultaneously.²¹ As a result, there may be an operational error in which an individual leg of a package transaction may be rejected by a DCO because the risk of the leg, measured in isolation, could cause a trader to exceed its credit limit; however, if the legs had been submitted in a different sequence or had been cleared simultaneously, the net risk may not have exceeded the credit limit and no legs would have been rejected. On May 1, 2014, the Divisions issued No-Action Letter 14-62, which in part permitted SEFs and DCMs to establish a “new trade, old terms” procedure for legs of a package transaction that had been rejected from clearing because of the sequencing of the

¹⁵ Staff Guidance at 2.

¹⁶ *Id.* at 3

¹⁷ *Id.* at 6.

¹⁸ *Id.*

¹⁹ No-Action Letter 13-66 (Oct. 25, 2013).

²⁰ No-Action Letter 14-50 (Apr. 18, 2014).

²¹ For purposes of this letter, a “package transaction” is a transaction involving two or more instruments: (1) that is executed between two or more counterparties; (2) that is priced or quoted as one economic transaction with simultaneous or near simultaneous execution of all components; (3) that has at least one component that is a swap that is made available to trade and therefore is subject to the CEA section 2(h)(8) trade execution requirement; and (4) where the execution of each component is contingent upon the execution of all other components.

submission of the legs.²² On September 30, 2014, the Divisions issued No-Action Letter 14-121, which extended that relief granted in No-Action Letter 14-62 until February 16, 2015.²³

Requested Relief

In its no-action request, WMBAA indicates that the industry continues to work on solutions to reduce operational and clerical errors but that, at this time, trades continue to be rejected as *void ab initio* because of readily correctable operational or clerical errors. WMBAA requests that the relief provided in No-Action Letter 13-66 be reinstated to provide additional time for SEFs to develop solutions for such errors.

WMBAA also indicates that because trades are required to be submitted for clearing immediately after execution, counterparties to a transaction may not have an opportunity to identify an error until after the transaction has cleared.

If an error is identified after a swap has cleared, any correction or cancellation necessarily would have to be undertaken by the DCO because only the DCO is able to make corrections or cancellations to swaps carried on its books. According to WMBAA, some DCOs decline or are unable to correct or cancel the swaps carried on their books. As a result, to undo a cleared erroneous swap, counterparties must arrange and execute a transaction that offsets the swaps carried on the DCO's books and, if the parties desire, execute a new transaction that reflects the correct terms agreed to by the counterparties. Similar to the no-action relief provided in No-Action Letter 13-66, WMBAA seeks time limited no-action relief from Commission Regulation 37.9(a)(2) regarding methods of execution for required transactions and Regulation 37.203(a)'s prohibition of pre-arranged trading, so that a SEF may permit counterparties to undo an erroneous cleared swap by executing a pre-arranged trade that offsets the swaps carried on the DCO's books, without requiring that trade to be executed pursuant to the methods set forth in Regulation 37.9(a)(2).

No-Action Relief

The Divisions are issuing this no-action letter to provide relief similar to that provided in No-Action Letters 13-66 and 14-50 and to permit a similar procedure to be followed in situations where an error is not discovered until after a swap has been cleared. Specifically, subject to the conditions listed below, the Divisions will not recommend that the Commission take any enforcement action against a SEF for failure to comply with Commission Regulation 37.9(a)(2) or against a DCM for failure to comply with Commission Regulation 38.500, regarding methods of execution or to comply with Commission Regulations' 37.203 and 38.152 prohibition against pre-arranged trading if, after a trade has been rejected for clearing, the SEF or DCM permits a new trade, with terms and conditions that match the terms and conditions of the original trade,

²² No-Action Letter 14-62 (May 1, 2014).

²³ No-Action Letter 14-121 (Sep. 30, 2014).

other than any such error and time of execution, to be submitted for clearing without having been executed pursuant to methods set forth in Commission Regulations 37.9(a)(2) or 38.500.

The Divisions also will provide this relief to the situation where an error is not discovered until after a swap has been cleared. Thus, relief is provided to a SEF or a DCM if, after a trade has been cleared and an error is discovered, the SEF or DCM permits a prearranged trade between the original parties that offsets the swaps carried on the DCO's books, without that trade having been executed pursuant to the methods required in Commission Regulations 37.9(a)(2) and 38.500. The SEF or DCM may also permit the original or intended²⁴ counterparties to enter into a pre-arranged transaction that reflects the terms to which the parties mutually assented without that trade having been executed pursuant to the methods set forth in Commission Regulations 37.9(a)(2) and 38.500.

This relief is subject to the following conditions:

1. The pre-arranged transactions subject to this relief must be only (1) for the correction of an operational or clerical error or omission made by the SEF, DCM, one of the counterparties, or an agent of one of the counterparties that causes a trade to be rejected from clearing and *void ab initio*, or (2) for the purpose of offsetting swaps carried on a DCO's books where a clerical or operational error or omission made by the SEF, DCM, counterparty, or an agent of the counterparty is not identified until after the trade has been cleared. In the latter situation, a new transaction that corrects the errors in the original transaction also is subject to this relief.²⁵
2. The SEF or DCM must have error trade rules that are consistent with Commission regulations and provide for trade price adjustments or trade cancellations and rules that are transparent to the market and subject to standards that are clear, fair and publicly available. Further, consistent with the obligations of SEFs and DCMs to prevent market abuses, such standards should account for whether a transaction cancellation or price adjustment will adversely impact market integrity, facilitate market manipulation or other illegitimate activity, or otherwise violate the CEA, Commission regulations, or the SEF's or DCM's rules.

²⁴ In certain instances, the wrong legal entity may be assigned as a counterparty to a trade. The relief will allow the swap with the wrong counterparties to be undone and the execution of a new swap with the correct counterparties.

²⁵ Staff notes that the relief will apply to the leg of a package transaction that is rejected from clearing or for which an error is discovered after the leg has been cleared. Accordingly, this letter provides relief similar to that provided in No-Action Letter 14-121 and a SEF or DCM may establish a "new trade, old terms" procedure for legs of a package transaction that had been rejected from clearing because of the sequencing of the submission of the legs. This relief does not apply to the legs of a package that have been accepted for clearing.

3. For swaps rejected for non-credit reasons, the new trade must be executed on the SEF or DCM and submitted for clearing as quickly as technologically practicable after receipt of notice of the rejection by the DCO to the clearing members, but, in any event, no later than one hour from the issuance of the notice.²⁶ For erroneous cleared swaps, the trade to offset the swaps carried on the DCO's books and the new transaction that corrects the errors in the original transaction must be executed and submitted for clearing no later than three days after the erroneous cleared swap was executed.
4. The SEF or DCM must have rules setting forth the conditions, if any, under which it will determine that an error has occurred, and the procedures it will follow to execute a trade subject to the relief set forth in this letter. The rules must provide that if the facility is able to determine how to correct an error, the facility will execute the new trades without obtaining consent from the counterparties. The rules must also provide what the facility will do if it is unable to determine how to correct an error. The facility may either not fix the error, or it may seek guidance on how to address the error from the counterparties. Any such guidance may not be implemented without consent from both counterparties.
5. With respect to swaps rejected from clearing for non-credit reasons, if the new transaction that corrects the errors in the original transaction is also rejected for clearing, it is *void ab initio* and the parties will not be provided a second opportunity to submit a new trade subject to the relief provided herein.²⁷
6. In making its determination whether to permit the execution of a trade subject to this relief, a SEF or DCM must make an affirmative finding that the trade or some term therein resulted from an error.²⁸
7. The SEF or DCM must report the swap transaction data to the relevant swap data repository ("SDR") as soon as technologically practicable after the original trade is rejected by the DCO, including:
 - i. A part 43 cancellation for the original trade;

²⁶ No-Action Letter 13-66 provided 30 minutes for the execution of a new swap. Staff has increased the time frame to 60 minutes in response to requests from market participants for such time.

²⁷ As explained in the Staff Guidance, all trades executed on or subject to the rules of a SEF or DCM that are rejected from clearing, whether for credit or non-credit reasons, are void *ab initio*. This no-action letter allows for the submission of a new trade with the old terms, correcting for the error, for non-credit rejections. However, submission of a second new trade with the original old terms is not permissible.

²⁸ A SEF is not required to keep any additional records with respect to conditions four and six.

- ii. A part 45 termination indicating that the original trade is void *ab initio*; and
- iii. Swap transaction data pursuant to Parts 43 and 45 for the newly executed trade(s).

Staff reminds SEFs and DCMs that both the erroneous trade and any subsequent trade subject to the relief in this letter must be subject to pre-execution credit checks that comply with Commission Regulation 1.73 and/or Regulation 23.609 and the Staff Guidance. In addition, both the erroneous trade and any subsequent trade subject to relief in this letter must be processed in accordance with the time frames set forth in Commission Regulations 1.74, 23.610, 39.12(b)(7), 43.3(e), 45.14, and the Staff Guidance.

This no-action relief shall commence on the date of issuance of this letter and shall expire on June 15, 2016. Staff expects that SEFs, DCMs and market participants will use this time to reduce the frequency of errors.

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 data reporting requirements and clearing requirements. This letter, and the no-action positions taken herein, represent the views of the Divisions 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 Divisions retain the authority to condition further, modify, suspend, terminate or otherwise restrict the terms of the no-action relief provided herein, in its discretion.

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 Jonathan Lave, Associate Director, Division of Market Oversight, at (202) 418-5983 or jlave@cftc.gov.

Sincerely,

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