

MEMO# 27283

June 6, 2013

CFTC Adopts Block Trade Rules

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TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 48-13
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 44-13
INVESTMENT ADVISER MEMBERS No. 37-13
SEC RULES MEMBERS No. 53-13 RE: CFTC ADOPTS BLOCK TRADE RULES

Recently, the Commodity Futures Trading Commission (“CFTC”) adopted procedures to establish appropriate minimum block sizes for large notional off-facility swaps and block trades, which benefit from a delay in public dissemination. [\[1\]](#) The new rules define the criteria for grouping swaps into separate categories and establish methodologies for setting appropriate minimum block sizes for each swap category. The CFTC also adopted measures to prevent public disclosure of identities, business transactions, and market positions of swaps market participants. Finally, the CFTC finalized rules that prohibit the aggregation of orders for different trading accounts to satisfy the minimum block size or cap size requirements except for orders aggregated by certain persons and rules that specify the eligible parties to a block trade. [\[2\]](#) The effective date of the rules is July 30, 2013.

Despite significant comments on the proposed rules, the CFTC adopted most of the rules substantially as proposed with a few modifications. [\[3\]](#) In response to concerns expressed by many commenters regarding the impact of the block rules on liquidity, the CFTC states several times in the Adopting Release that, if market participants conclude that the CFTC has set minimum block sizes for a specific swap category in a way that will materially reduce market liquidity, then participants should submit data to support their conclusion. The CFTC notes that it may exercise its own legal authority to take action by rule or order to mitigate the potential effects on market liquidity with respect to swaps in a particular swap category in response to a submission by market participants or through its own surveillance of swaps market activity.

This memorandum briefly summarizes the final rules.

I. Appropriate Minimum Block Size

The CFTC provided a two-period (initial and post-initial), phased-in approach for determining minimum block sizes. [\[4\]](#) Specifically, the CFTC adopted the criteria for distinguishing among swap categories for the swap asset classes and the methodologies for calculating appropriate minimum block sizes for each swap asset class. Each swap

category in each asset class will be subject to a common appropriate minimum block size. No trades, however, of equity swaps will be treated as block trades or large notional off-facility swaps and, therefore, no equity swap transactions will be subject to a time delay.

Appendix F to Part 43 generally provides the initial appropriate minimum block sizes by asset class. The CFTC will publish the post-initial appropriate minimum block size at least once a year on its website, and the CFTC may update the minimum block sizes more frequently if circumstances warrant. These sizes would become effective on the first day of the second month following the date of publication.

Swap Categories

The CFTC adopted the swap categories for the different asset classes that it proposed with certain modifications. The CFTC adopted the swap categories for interest rate swaps based on combinations of tenor and currency [5] and for credit default swaps (“CDS”) based on combinations of tenor and conventional spread. [6] With respect to interest rate swaps, the CFTC included in the final rules an additional tenor grouping – less than 46 day tenor group – to provide great granularity.

For the FX asset class, [7] the CFTC established swap categories based on unique currency combinations between one super-majority currency paired with one of the following: (1) another super-majority currency; (2) a majority currency; or (3) a currency of Brazil, China, Czech Republic, Hungary, Israel, Mexico, Poland, Russia, or Turkey. [8] This approach differs from the proposal in that the adopted swap categories will not include the unique currency combinations between major currencies and other major currencies, between major currencies and each of the ten additional enumerated non-major currencies, and between the ten additional enumerated non-major currencies.

For the other commodity asset class, the CFTC adopted the swap categories based on three sets of groupings. The first group is of swaps that are economically related to one of the contracts in Appendix B to Part 43. The second group is of swaps that are economically related to specific futures contracts that are subject to the block trade rules of a designated contract market (“DCM”). The third set includes all other commodity swaps and the appropriate swap category would be determined based on swaps sharing a common product type (referenced in Appendix D).

Methodologies

Interest Rate and Credit Asset Classes

For interest rate swaps and credit asset classes, the CFTC adopted the 50-percent notional amount calculation to determine appropriate minimum block sizes in the initial period. For the post-initial period, the CFTC will use the 67-percent notional amount calculation. In response to comments, the CFTC determined to use a one-year window of swap transactions and pricing data rather than the proposed three-year rolling window of data.

FX Asset Class

For the FX asset class, the CFTC will set the appropriate minimum block sizes based on whether such swap is economically related to a futures contract during the initial period. For these swaps, the appropriate minimum block sizes will be based on the block trade size thresholds set by DCMs for economically-related futures contracts. For non-futures related swaps in the FX asset class in the initial period, all such swaps will be treated as block

trades or large notional off-facility swaps. For the post-initial period, the CFTC adopted the 67-percent notional amount calculation to determine appropriate minimum block sizes for swaps in the categories grouped by unique currency combinations. The remainder of the swaps not included in those groups will continue to be treated as blocks.

Other Commodity Asset Class

For the other commodity asset class, the initial appropriate minimum block size will depend on the three types of other commodity swap categories: (1) those swaps based on contracts listed in Appendix B to part 43 of the CFTC regulations; (2) swaps that are economically related to certain futures contracts; and (3) other swaps. For swaps based on contracts listed in appendix B and to certain other futures contracts, the initial appropriate minimum block sizes would be set based on the block sizes for related futures contracts set by DCMs. For swaps that are economically related to a futures contract listed in Appendix B that is not subject to a DCM block trade rule, these swaps will not be treated as a block trade or large notional off-facility swap. All other swaps in the other commodity asset class will be treated as block trades or large notional off-facility swaps. For the post-initial period, the appropriate minimum block sizes for swaps in the other commodity asset class will be determined by using the 67-percent notional amount calculation.

The CFTC also adopted special rules that apply to the determination of the appropriate minimum block sizes for: (1) swaps with optionality; (b) swaps with composite reference prices; (3) physical commodity swaps; (4) currency conversions; and (5) successor currencies.

II. Anonymity Protections for Public Dissemination of Swap Transactions and Pricing Data

To protect the identities of counterparties and to maintain the anonymity of their business transactions and market positions in connection with the public dissemination of publicly reportable swap transactions, the CFTC is adopting various measures.

First, the CFTC established cap sizes for notional and principal amounts that would mask the total size of a swap transaction if it equals or exceeds the appropriate minimum block size for a given swap category. In the initial period, the final rules set the cap size for each swap category as the greater of the interim cap sizes in all five asset classes set forth in the Real Time Reporting Rules [\[9\]](#) or the appropriate minimum block size for the respective swap category. For the post-initial period, the CFTC adopted a 75-percent notional amount calculation to determine the appropriate cap sizes for all swap categories. The CFTC will publish the post-initial cap sizes on its website. The post-initial cap sizes also will become effective on the first day of the second month following the date of publication.

Second, the CFTC adopted provisions that would require SDRs to use a certain system to mask the specific delivery or pricing points that are a part of an underlying asset in connection with the public dissemination of swap transaction and pricing data for certain swaps in the other commodity asset class.

III. Aggregation of Orders

Aggregation Prohibition and Exceptions

The CFTC also adopted the rule prohibiting the aggregation of orders for different trading accounts to satisfy the minimum block size or cap size requirements except for orders

aggregated by certain persons. Aggregation will be permissible if done on a DCM or swap execution facility (“SEF”) by a person who has more than \$25 million in total assets under management and is a person who is:

1. a commodity trading advisor (“CTA”) registered pursuant to Section 4n of the CEA or exempt from such registration under the CEA, or a principal thereof, and who has discretionary trading authority or directs client accounts;
2. an investment adviser who has discretionary trading authority or directs client accounts and satisfies the criteria of Rule 4.7(a)(2)(v) under the CEA; or
3. a foreign person who performs a similar role or function as the persons described above in (1) or (2) and is subject as such to foreign regulation.

To satisfy the criteria under Rule 4.7(a)(2)(v), an investment adviser must be registered pursuant to section 203 of the Investment Advisers Act of 1940 or pursuant to the laws of any state, or principal thereof, and (1) has been registered and active as such for two years or (2) provides securities investment advice to securities accounts which, in the aggregate, have total assets in excess of \$5 million deposited at one or more registered securities brokers. The CFTC adopted the rule as proposed and disagreed with ICI that some of the criteria were unnecessary to ensure the legitimacy of aggregated orders. Moreover, the CFTC states that it does intend to include large notional off-facility swaps in the aggregation prohibition, but the exception is limited to aggregation done on a DCM or SEF.

Eligible Block Trade Parties and Exceptions

The CFTC also adopted a rule that provides that parties to a block trade must qualify as eligible contract participants (“ECPs”). [10] The rule includes an exception providing that a DCM may allow certain CTAs, investment advisers and foreign persons to transact block trades for customers who are not ECPs if such CTAs, investment advisers and foreign persons have more than \$25 million in total assets under management. The persons eligible for the exception are the same as those excepted from the aggregation prohibition.

In addition, the rule requires that persons transacting block trades on behalf of customers receive prior written instructions or consent from the customer. The CFTC declined to adopt ICI’s clarification that only a person transacting a block trade on behalf of a customer who is not an ECP must receive prior written instruction or consent. The CFTC took the view that all customers, whether or not they are ECPs, should be fully informed of the use of block trades. In addition, the CFTC states that a general grant of investment discretion or notice to the customer would not satisfy this requirement.

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endnotes

[1] *Procedures to Establish Appropriate Minimum Block Sizes for Large Notional Off-Facility Swaps and Block Trades*, 78 FR 32866 (May 31, 2013), available at <http://www.gpo.gov/fdsys/pkg/FR-2013-05-31/pdf/2013-12133.pdf> (“Adopting Release”). In March 2012, the CFTC re-proposed rules to specify the procedures for determining block

trade sizes pursuant to section 727 of the Dodd-Frank Wall Street Reform and Customer Protection Act ("Dodd-Frank Act"). See *Procedures to Establish Appropriate Minimum Block Sizes for Large Notional Off-Facility Swaps and Block Trades*, 77 FR 15460 (Mar. 15, 2012), available at

<http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-5950a.pdf>

("Block Reproposal"). For a summary of the Block Reproposal, see ICI Memorandum No. 25940 (May 23, 2013), available at http://www.ici.org/my_ici/memorandum/memo25940. In January 2012, when the CFTC adopted rules implementing real-time reporting of swap transactions as mandated by the Dodd-Frank Act, it deferred the adoption of rules relating to the determination of block trade sizes. The CFTC did, however, adopt time delays for public dissemination of block trades and large notional off-facility swaps and included interim time delays for all swaps until the minimum block sizes are finalized. See Appendix C to Part 43 – Time Delays for Public Dissemination – under the Commodity Exchange Act ("CEA"); *Real-Time Public Reporting of Swap Transaction Data*, 77 FR 1182 (Jan. 9, 2012) ("Real Time Reporting Rules"). For a summary of the Real Time Reporting Rules, see ICI Memorandum No. 25757 (Dec. 29, 2011), available at http://www.ici.org/my_ici/memorandum/memo25757.

[2] *Rules Prohibiting the Aggregation of Orders to Satisfy Minimum Block Sizes or Cap Size Requirements, and Establishing Eligibility Requirements for Parties to Block Trades*, 77 FR 38229 (June 27, 2012), available at

<http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-15481a.pdf>.

For a summary of the Proposal, see ICI Memorandum No. 26269 (June 27, 2012), available at http://www.ici.org/my_ici/memorandum/memo26269.

[3] For a summary of the ICI comment letters on the proposed rules, see ICI Memorandum Nos. 26158 (May 15, 2012), available at

http://www.ici.org/my_ici/memorandum/memo26158 and 26343 (July 26, 2012), available at http://www.ici.org/my_ici/memorandum/memo26343.

[4] On or after April 10, 2014 (the date as of which the CFTC and the swap data repositories ("SDRs") will have one year of reliable data), the CFTC will establish the post-initial minimum block sizes.

[5] The CFTC adopted three currency categories – Super-Major Currencies (i.e., US Dollar, EU Euro, UK Pound Sterling, and Japan Yen), Major Currencies (i.e., Australian Dollar, Switzerland Franc, Canadian Dollar, Republic of South Africa Rand, Republic of Korea Won, Kingdom of Sweden Krona, New Zealand Dollar, Kingdom of Norway Krone, and Denmark Krone), and Non-Major Currencies (i.e., all other currencies) and nine tenor groups for the interest rate asset class. The tenor of a swap refers to the amount of time from the effective or start date of a swap to the end date of such swap.

[6] For the credit asset class, the CFTC adopted six tenor groups: (1) zero to two years; (2) over two to four years; (3) over four to six years; (4) over six to eight-and-a-half years; (5) over eight-and-a-half to 12.5 years; and (6) greater than 12.5 years. The CFTC also adopted three ranges for the conventional spreads. The term "conventional spread" represents the equivalent of a swap dealer's quoted spread (i.e., an upfront fee based on a fixed coupon and using standard assumptions such as auctions and recovery rates).

[7] Because the Secretary of the Department of the Treasury has exempted FX swaps and FX forwards from the definition of "swap" under the CEA, the real-time reporting requirements apply only to FX options and non-deliverable FX forwards.

[8] Rule 43.6(b)(4)(i)(C). The Adopting Release, however, includes New Zealand on the list of countries. Unique currency combinations not included in these groups may be treated as blocks.

[9] See Real Time Reporting Rules, *supra* note 1.

[10] ECPs include, among others, an investment company subject to regulation under the Investment Company Act of 1940 acting for its own account and an investment adviser subject to regulation under the Investment Advisers Act of 1940 acting as investment manager or fiduciary for certain persons (including a registered fund). See Section 1a(18) of the CEA.

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