MEMO# 25940

February 28, 2012

CFTC Issues Reproposal on Block Trades

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TO: DERIVATIVES MARKETS ADVISORY COMMITTEE No. 10-12
CLOSED-END INVESTMENT COMPANY COMMITTEE No. 8-12
SEC RULES COMMITTEE No. 14-12 RE: CFTC ISSUES REPROPOSAL ON BLOCK TRADES

The Commodity Futures Trading Commission ("CFTC") has re-proposed rules specifying the criteria for determining block trade sizes. [1] Specifically, the Reproposal defines the criteria for determining swap categories and provides the methodologies for setting appropriate minimum block sizes for each swap category. The Reproposal also includes additional measures to prevent public disclosure of the identities, business transactions, and market positions of swap market participants. A summary of the Reproposal is provided below.

Comments are due within 60 days of publication in the Federal Register. We will hold a conference call on Thursday, March 15 at 2:00 pm ET to discuss the Reproposal and possible ICI's comments. The dial-in number for the call is 800-619-9255 and the passcode is 57310. If you plan to participate, please RSVP to Ruth Tadesse via email (rtadesse@ici.org).

Background and Proposed General Approach to Block Trades

Pursuant to Section 2(a)(13) of the Commodity Exchange Act ("CEA"), in December 2010, the CFTC proposed rules to implement real-time reporting of swap transactions as mandated by the Dodd-Frank Act. [2] As part of those rules, the CFTC proposed definitions for the terms "large notional off-facility swap" and "block trade," methods for determining the appropriate minimum block sizes for large notional off-facility swaps and block trades, and the time delay that would apply to the reporting of block trades and large notional off-facility swaps. The CFTC received a significant number of comments on the proposal, including on the criteria for setting appropriate minimum block sizes and the time delays. In January 2012, the CFTC adopted rules relating to the reporting of swap data but deferred the adoption of rules relating to the determination of block trade sizes. [3] 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.

In this release, the CFTC proposes to phase-in the regulation of minimum block sizes in two periods – initial period and post-initial period. The CFTC proposes to establish initial appropriate minimum block sizes for each category of swaps within the interest rate, credit, foreign exchange ("FX"), and other commodity asset classes (in proposed Appendix F to part 43). The proposed initial period would expire following the publication by the CFTC of post-initial appropriate minimum block sizes, which would be set no less than once each calendar year. Each swap category in each asset class would be subject to a common appropriate minimum block size. No trades, however, of equity swaps would be treated as block trades and, therefore, no equity swap transactions and trades would be subject to a time delay.

The CFTC intends to publish the post-initial appropriate minimum block size on its website, and these sizes would become effective on the first day of the second month following the date of publication.

Swap Categories

For the initial and post-initial periods, the CFTC proposes to group swaps in the asset classes into certain swap categories. Based on its analysis of swap data, the CFTC proposes to define swap categories for interest rate swaps based on tenor and underlying currency [4] and for credit default swaps based on tenor and conventional spreads. [5] For the FX asset class, the CFTC proposes to establish swap categories based on currency combinations. For the other commodity asset class, the CFTC proposes to determine swap categories based on groupings of economically related swaps and groupings on swaps sharing a common product type.

Methodology for Interest Rate and Credit Asset Classes

The CFTC proposes to determine the initial and post-initial appropriate minimum block sizes for swaps in the interest rate and credit asset classes by using a 67-percent notional amount calculation (a nine-step calculation methodology) based on three years of data and excluding certain large transactions from the data set. [6] According to the CFTC, the 67-percent notional amount calculation is to ensure that approximately two-thirds of the sum total of all notional amounts would be reported on a real-time basis for each swap category. As an alternative, the CFTC requests comment on whether it should use a 50-percent notional amount calculation methodology. It appears from an exchange between Commissioner Sommers and the staff at the open meeting that the proposal included the 50-percent notional amount calculation rather than the 67-percent notional amount calculation until the evening before the meeting.

Methodology for FX Asset Class

For the initial period, the CFTC proposes to set appropriate minimum block sizes for swaps in the FX asset class based on whether such swap is economically related [7] to a futures contract. Therefore, the CFTC would establish the appropriate minimum block sizes for futures-related swaps based on the block trade size thresholds set by the designated contract markets ("DCMs") for economically-related futures contracts. For non-futures related swaps in the FX asset class, the CFTC would treat all non-futures related swaps in the FX asset class as block trades or large notional off-facility swaps and subject to a time delay. In the post-initial period, the CFTC would use the 67-percent notional amount calculation to determine appropriate minimum block sizes for each swap category of transactions in the FX asset class.

Methodology for Other Commodity Asset Class

The CFTC proposes to determine the appropriate minimum block size in the initial period depending on the type of other commodity swap categories: (1) swaps based on contracts listed in appendix B to part 43; (2) swaps economically related to certain futures contracts; (3) and other swaps. With respect to swaps that reference or are economically related to one of the futures contracts listed in appendix B to part 43 (other than national gas and electricity swaps), [8] the CFTC would set the appropriate minimum block size based on the block sizes for related futures contracts set by DCMs. If the swaps are not subject to a DCM block trade rule, those transactions would not be treated as a block trade or large notional off-facility swap. All non-futures-related swaps in the other commodity asset class would be treated in the initial period as block trades or large notional off-facility swaps.

For the post-initial period appropriate minimum block sizes, the CFTC would use the 67-percent notional amount calculation.

Certain Types of Swaps

Finally, the CFTC proposes special rules for swaps with optionality, swaps with composite reference prices, [9] physical commodity swaps, [10] currency conversion, and successor currencies.

Measures to Protect Anonymity of Counterparties, Business Transactions, and Market Positions

To protect the identities of counterparties and business transactions and market positions of counterparties as required by the CEA, the CFTC is proposing several measures, including the establishment of notional cap sizes and requirements to mask the geographic details for swaps in the other commodity asset class.

The CFTC proposes to define the term “cap size” as the maximum limit of the principal, notional amount of a swap that is publicly disseminated. Moreover, the CFTC proposes to establish initial cap sizes for each swap category within the five asset classes and the process for the post-initial period by which the CFTC would establish post-initial cap sizes for each swap category. For the initial period, the CFTC would set the cap size for each swap category as the greater of the interim cap size provided in the Real-Time Reporting Release or the appropriate minimum block size for the respective swap category. During the post-initial period, the CFTC proposes to use the 75-percent notional amount calculation (a nine-step calculation methodology). The CFTC also is considering several other alternative calculations in lieu of the 75-percent notional amount calculation to determine the post-initial cap sizes.

Finally, the CFTC proposes 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 other commodity asset class by requiring the use of regions or markets that are associated with these underlying assets.

Jennifer S. Choi
Senior Associate Counsel – Securities Regulation

endnotes

[1] Procedures to Establish Appropriate Minimum Block Sizes for Large Notional Off-Facility Swaps and Block Trades, RIN 3038-AD08, available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister022312.pdf (Feb. 23, 2012) ("Reproposal").

[2] Real-Time Public Reporting of Swap Transaction Data, 75 FR 76140 (Dec. 7, 2010).

[3] Real-Time Public Reporting of Swap Transaction Data, 77 FR 1182 (Jan. 9, 2012) ("Real Time Reporting Release"); see ICI Memorandum No. 25757 (Dec. 29, 2011)

[4] The CFTC proposes 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 eight tenor groups for interest rate asset class.

[5] For the credit asset class, the CFTC proposes 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 proposed three ranges for the conventional spreads.

[6] The nine steps would include: (1) selecting all of the publicly reportable swap transactions within a specific swap category using a rolling three-year window of data beginning with a minimum of one year's worth of data and adding one year of data for each calculation until a total of three years of data is accumulated; (2) converting to the same currency or units and using a "trimmed data set;" (3) determining the sum of the notional amounts of swaps in the trimmed data set; (4) multiplying the sum of the notional amount by 67 percent; (5) ranking order the observations by notional amount from least to greatest; (6) calculating the cumulative sum of the observations until the cumulative sum is equal to or greater than the 67-percent notional amount calculated in step 4; (7) selecting the notional amount associated with that observation; (8) rounding the notional amount of that observation to two significant digits, or if the notional amount associated with that observation is already significant to two digits, increasing that notional amount to the next highest rounding point of two significant digits; and (9) setting the appropriate minimum block size at the amount calculated in step 8.

[7] Proposed amendments to Section 43.2 would define "economically related" to mean a direct or indirect reference to the same commodity at the same delivery location or locations, or with the same or a substantially similar cash market price series.

[8] For all swaps that reference natural gas or electricity swap contracts proposed to be listed in appendix B to part 43, the CFTC proposes to set the initial appropriate minimum block size at $25 million.

[9] "Swaps with composite reference prices" would be defined as swaps based on reference prices composed of more than one reference price that are in differing swap categories.

[10] “Physical commodity swap” would be defined as a swap in the other commodity asset class that is based on a tangible commodity.
