

**MEMO# 32222**

February 20, 2020

# CFTC Proposes Amendments to SEF Regulations for Package Transactions, Error Trades, and Block Trades

[32222]

February 20, 2020 TO: Derivatives Markets Advisory Committee RE: CFTC Proposes Amendments to SEF Regulations for Package Transactions, Error Trades, and Block Trades

In January, the Commodity Futures Trading Commission (CFTC or “Commission”) approved a proposal (“Proposal”) that would permit market participants on swap execution facilities (SEFs) to use flexible execution methods to execute component swaps of certain package transactions, swap block trades, and transactions to resolve swap error trades.<sup>[1]</sup> The Proposal generally would codify a series of existing no-action letters issued by the CFTC’s Division of Market Oversight (DMO) in several areas, as described below. Comments on the Proposal are due to the CFTC on April 20.

**At this time, ICI does not plan to submit comments on the Proposal. If you have comments or concerns about the Proposal, however, please contact Sarah Bessin at (202) 326-5835 or [sarah.bessin@ici.org](mailto:sarah.bessin@ici.org) by February 28.**

## Package Transactions

For certain categories of package transactions,<sup>[2]</sup> proposed Regulation 37.9(d)(2)-(4) would provide market participants with the flexibility to execute a component swap that is a “Required Transaction”<sup>[3]</sup> through any SEF execution method offered for “Permitted Transactions.”<sup>[4]</sup> Regulation 37.9(a)(2) requires component swaps that are Required Transactions to be executed through a SEF’s order book or request-for-quote (RFQ) system, but DMO has provided ongoing no-action relief from that requirement under Letter 17-55 with respect to some package transaction categories. The proposed regulations would codify that no-action relief<sup>[5]</sup> with respect to package transactions in which:

- At least one of the component swaps is exclusively subject to the CFTC’s jurisdiction, but is otherwise not subject to the CFTC clearing requirement under CEA Section 2(h)(1)(A).<sup>[6]</sup>
- At least one of the components is not a swap.<sup>[7]</sup> Proposed Regulation 37.9(d)(3)(i)-(iv), however, would exclude package transactions in which (i) all other swap components are US Treasury securities; (ii) all other non-swap components are futures contracts; (iii) all other swap components are agency mortgage-backed securities; or

- (iv) one component is a bond issuance in the primary market.
- At least one of the components is a swap over which the CFTC does not have exclusive jurisdiction, e.g., a mixed swap.[\[8\]](#)

The Commission believes that execution flexibility on SEFs is appropriate for these package transaction types based on their complex and bespoke nature.[\[9\]](#) The Commission recognizes that applying the order book or RFQ system requirements could otherwise force market participants to execute these packages on a “leg-by-leg” basis, which would increase transaction costs and execution risk.

In addition to the execution flexibility provided under proposed Regulation 37.9(d)(2)-(4), proposed Regulation 36.1(a) would exempt from the trade execution requirement under CEA Section 2(h)(8) any swap component of a package transaction that involves a bond issuance in the primary market.[\[10\]](#) The Commission noted that this type of package transaction has not been conducive to SEF execution, due in part to the lack of an available SEF trading system or platform.

## Error Trades

Proposed Regulation 37.9(e)(2) would establish a general SEF error trade policy requirement. A SEF would be required to maintain rules and procedures for resolving swap error trades on its facility that are (i) fair, transparent, and consistent; (ii) allow for timely resolution; and (iii) require market participants to promptly notify the SEF of an error trade, including trades subsequently executed to resolve the error.

Proposed Regulation 37.9(e)(2) would also require a SEF to permit market participants to resolve error trades by executing swaps—both Required and Permitted Transactions—through any SEF execution method offered for Permitted Transactions. For error trades that have been rejected from clearing (and thus declared void ab initio), proposed Regulation 37.9(e)(2)(i)(A) would permit counterparties to execute and submit a “correcting trade”[\[11\]](#) as soon as technologically practicable, but no later than one hour after the derivatives clearing organization (DCO) provides notice of the rejection. For error trades that have been accepted for clearing, proposed Regulation 37.9(e)(2)(i)(B) would permit counterparties to execute both an “offsetting trade”[\[12\]](#) and a “correcting trade,” both of which must be executed as soon as technologically practicable, but no later than three days after the error trade was accepted for clearing at the DCO. If a correcting trade is rejected from clearing, proposed Regulation 37.9(e)(2)(ii) would prohibit the counterparties from executing another correcting trade.

The proposed rule codifies the existing no-action relief provided under Letter 17-27[\[13\]](#) by allowing correcting and/or offsetting trades that are Required Transactions to be executed through flexible execution methods. The Commission believes that flexible execution methods, in lieu of order book or RFQ system requirements, promote SEF operational efficiency and allow a SEF to tailor error trade protocols to its trading and trade processing systems. The proposed rule also codifies two existing conditions from the no-action relief—the timing requirements and the prohibition on executing additional correcting trades. The Commission believes that these limitations are consistent with the goal of promoting straight-through processing.

The proposed rule, however, differs from Letter 17-27 in a couple of key respects. First, it excludes some conditions of the existing no-action relief, including the requirement that a SEF affirmatively determine that an error has occurred prior to allowing the counterparties to correct that error.[\[14\]](#) Second, the proposed rule appears to reduce the existing

flexibility for resolving error trades that involve Permitted Transactions—correcting and/or offsetting trades that are Permitted Transactions would be subject to the timing requirements and prohibition on additional correcting trades. The Commission, however, requests comment on whether these requirements should apply.

## **Block Trades**

The Proposal would amend the existing “block trade” definition under Regulation 43.2 to allow market participants to execute swap block trades on a SEF trading system or platform, excluding an order book. The proposed amendment would codify the current no-action relief provided in Letter 17-60 from the requirement that a block trade “occur away” from a SEF’s or designated contract market’s (DCM) trading system or platform, but pursuant to the SEF’s or DCM’s rules and procedures. The Commission states that continuing to permit on-SEF block trade execution, consistent with the current no-action relief, would allow clearing members to continue complying with pre-execution credit screening requirements under Regulation 1.73 for swaps that are intended to be cleared, and allow SEFs to facilitate those screenings as required under Regulation 37.702(b).

The proposed amendment, however, would also allow market participants to execute swap block trades that are not intended to be cleared on a SEF’s non-order book trading system or platform. The Commission states that providing a consistent approach to both types of block trades would help reduce operational complexity for both SEFs and market participants.

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## **endnotes**

[1] *Swap Execution Facility Requirements and Real-Time Reporting Requirements*, 84 Fed. Reg. 70446 (Feb. 19, 2020), *available at* <https://www.cftc.gov/media/3371/federalregister013020c/download>.

[2] Proposed Regulation 37.9(d)(1) specifies that a “package transaction” consists of two or more component transactions executed between two or more counterparties where (i) at least one component transaction is a Required Transaction; (ii) execution of each component transaction is contingent upon the execution of all other component transactions; and (iii) the component transactions are priced or quoted together as one economic transaction with simultaneous or near-simultaneous execution of all components. This proposed definition is similar to the definition provided under the current no-action relief. CFTC Letter No. 17-55 (Oct. 31, 2017), *available at* <https://www.cftc.gov/csl/17-55/download>.

[3] Regulation 37.9(a)(1) defines a “Required Transaction” as any transaction involving a swap that is subject to the trade execution requirement under Commodity Exchange Act (CEA) Section 2(h)(8). Swaps that are subject to the trade execution requirement have been “made available to trade” (MAT) pursuant to a regulatory determination process.

[4] Regulation 37.9(c)(1) defines a “Permitted Transaction” as any transaction not involving

a swap that is subject to the trade execution in CEA Section 2(h)(8). Regulation 37.9(c)(2) allows a SEF to offer any execution method for a Permitted Transaction.

[5] The proposed regulations, however, would not codify the no-action relief provided with respect to package transactions in which all other components are futures contracts. The current no-action relief designates this category as “MAT/Futures.” CFTC Letter No. 17-55. The relief for component swaps in that category is currently set to expire on November 15, 2020.

[6] The current no-action relief designates this category as “MAT/Non-MAT Uncleared.” CFTC Letter No. 17-55.

[7] The current no-action relief designates this category as “MAT/Non-Swap Instrument.” CFTC Letter No. 17-55.

[8] The current no-action relief designates this category as “MAT/Non-Exclusive CFTC Swap.” CFTC Letter No. 17-55.

[9] Based on the complexity of these types of package transactions, proposed Regulation 37.3(a)(4) also would provide a SEF with an exception to the “minimum trade functionality” requirement, which requires a SEF to offer an order book for all of its listed swaps, including swap components of package transactions in the categories specified above.

[10] The current no-action relief designates this category as “MAT/New Issuance Bond.” CFTC Letter No. 17-55.

[11] Proposed Regulation 37.9(e)(1)(i) defines “correcting trade” as a trade executed and submitted for clearing to a registered derivatives clearing organization [DCO] or a [DCO] that the Commission has determined is exempt from registration, with the same terms and conditions as an error trade other than any corrections to any operational or clerical error and the time of execution.

[12] Proposed Regulation 37.9(e)(1)(iii) defines “offsetting trade” as a trade executed and submitted for clearing to a registered [DCO], or a [DCO] that the Commission has determined is exempt from registration, with terms and conditions that economically reverse an error trade that was accepted for clearing.

[13] CFTC Letter No. 17-27 (May 30, 2017), *available at* <https://www.cftc.gov/csl/17-27/download>.

[14] CFTC Letter No. 17-27 at 6 (Conditions 4 and 6). Instead, the proposed rule would allow a SEF to permit counterparties to address an error trade without prior authorization and conduct an ex post review of any offsetting and/or correcting trades.