Block Trades, EFRPs and Assorted Other Trade Practice Issues: A Practical Guide of Current Status

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With some frequency, Katten attorneys field questions from clients about exchange rules on off-exchange execution of futures and options on futures.[1] This Advisory provides a high-level overview on this topic in connection with four principal derivatives exchange organizations: Chicago Mercantile Exchange Group (CME), ICE Futures U.S. (IFUS), ICE Futures Europe (IFEU) and Cboe Futures Exchange (CFE). In addition, it offers some perspective on other futures trade practice issues that have been recent focus areas for US regulators.

Block Trades and EFRPs in Futures

Commodity Futures Trading Commission (CFTC) Rule 1.38 requires futures and options on futures to be executed by "open and competitive methods" – except where transactions are executed in a "noncompetitive" manner in compliance with designated contract market rules specifically providing for such noncompetitive execution.[2]

Exchange rules provide for two kinds of noncompetitive execution of futures: block trades and exchange of futures for related positions,[3] or EFRPs (another type of commonly exchange approved noncompetitive transaction is the so-called "office trade" or "transfer trade" – e.g., transfers of cleared trades from one clearing member to another).

Block Trades[4]

In futures, a block trade:

- is a privately negotiated transaction in an eligible contract that meets certain quantity thresholds (as prescribed under exchange rules);
- is executed apart from the public auction market (that is, not on the central limit order book or in the trading pit or ring);
- cannot be transacted anonymously on an exchange or trading venue, but can be executed on electronic trading facilities – such as the Clearport or ICE Block platforms – which allow counterparties to interact directly;

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1 Indeed, in response to these inquiries, during June 2022 Katten welcomed representatives from the CFTC's Division of Enforcement, the CME Group's Market Regulation Department, and Tradeweb Markets for a hybrid seminar and webinar at Katten's New York City office to discuss the regulation of off-exchange futures, and various trade practice issues. A link to the webinar is available here.

2 CFTC Rule 1.38, 17 CFR §1.38.

3 Also referred to as: exchange of futures for related positions (EFRP), exchange of contracts for related positions (ECRP), exchange for physical (EFP), exchange for risk (EFR), exchange for swaps (EFS) and exchange of options for options (EOO).

4 See, e.g., CME Rule 526 (and the CME Market Regulation Advisory Notice on Block Trades, available here); IFUS Futures US Rule 4.07 (and the IFUS US Block Trade FAQs, available here); IFEU Rule F.7 (and the IFEU Policy on Block Trades and Asset Allocations, available here); CFE Rule 415 (and CFE Regulatory Circular RG18-018 on Block Trades, available here).

- must be transacted at a price that is fair and reasonable in light of the size of transaction and comparable prices and sizes in related markets;
- must be submitted to the Exchange once consummated – generally within five to 15 minutes, depending on the contract (for blocks done outside of exchange business hours that clock starts when the exchange reopens).

Exchange for Related Positions[5]

EFRPs involve a privately negotiated futures transaction and the simultaneous execution of an equivalent quantity in a related cash product or OTC derivative instrument corresponding to the asset underlying the exchange contract – that is, an EFRP enables market participants to post a futures contract to the clearing house against a negotiated and executed cash, physical or OTC transaction or agreement.

Generally:

- An EFRP involves two legs: one party to the EFRP is the buyer of the exchange contract and the seller of the related position and the other party is the seller of the Exchange contract and the buyer of the related position.
- The related position component of an EFRP may not be a futures contract or option on a futures contract, a listed equity option, or a swap executed on a swaps execution facility or subject to a swap facility's rules.
- EFRPs must be transacted at commercially reasonable prices; market participants may be required to demonstrate that EFRPs executed at prices away from the prevailing market were executed for legitimate purposes (that is, not as pretext for moving assets from one account to another without the incurrence of market risk – sometimes referred to as a "money pass").
- The quantity of the related position component must be approximately equivalent to the quantity of the exchange component – although this is not to say quantities need to be identical, since appropriate hedge ratios may be used to establish equivalency. This is often another area that exchange market regulatory staff may scrutinize in inquiries after the fact.
- "Transitory" EFRPs are prohibited – that is, the execution of one EFRP may not be contingent upon the execution of another EFRP between the same parties (or the offset solely of one of the legs of the EFRP), resulting in the offset of the related positions without incurrence of material market risk. Some exchanges, however, do permit "immediately offsetting" EFRPs in FX transactions.[6]
- As for block trades, EFRPs must be submitted to the exchange for clearing, as soon as possible following execution (generally, the time at which the deal is priced) but no later than end of the day.

Fair and Reasonable Pricing versus Commercially Reasonable Pricing

Fair and Reasonable

Block trades must be transacted at prices that are fair and reasonable, considering (i) the size of the transaction; (ii) the prices and sizes of other transactions in the same contract at the relevant time; (iii) the prices and sizes of transactions in other relevant markets including the underlying cash market and related futures market, at the relevant time; and (iv) the circumstances of the markets or the parties to the block trade. The policy concern

[5] See, e.g., CME Rule 538 (and Market Regulation Advisory Notice on Exchange for Related Positions, available here); IFUS Rule 4.06 (and the IFUS EFRP FAQs, available here); IFEU Rule F.5 (and the IFEU Guidance on the Exchange for Physical (EFP), Exchange for Swap (EFS), Soft Commodity Exchange for Related Positions (EFRP) and Basis Trading facilities, available here); CFE Rule 414 (and CFE Regulatory Circular 20-003 on Exchange of Contract for Related Position Transactions, available here).

[6] But see IFEU Guidance on EFS, EFR and EFRPs at section 3 ("'Transitory' EFSs – where the original underlying swap leg is offset/cancelled by a back-to-back swap and then replaced by a futures position as part of the same strategy – *are* permitted. Each swap leg must be able to stand alone if executed singly, and must bear genuine economic risk.")

underlying the "fair and reasonable" pricing requirement for blocks is that block trade prices are publicly reported to the market (separately from trades done on the order book or in the trading pit or ring).[7]

Commercially Reasonable

By contrast, the pricing standard for EFRPs is that they be transacted at commercially reasonable prices as are mutually agreed to by the parties to the transaction (in most cases, provided that the price conforms with applicable futures price increments or option premium increments). Unlike block trades, the prices of the exchange component of EFRPs are not disseminated to the market; because those prices are inherently tied to the related position component, they are subject to the less prescriptive standard of commercial reasonableness.[8]

Common Issues Concerning Block Trades and EFRPs

Reporting Issues

Exchange rules require block trades to be reported promptly after execution – that is, after a trade is agreed in principle. Specific reporting deadlines vary by contract; CME, IFUS and ICFEU deadlines are either five or 15 minutes; the CFE deadline is 10 minutes for all eligible contracts.[9] In addition to reporting timely, market participants must also accurately report the execution time of the block trade. Late reporting and inaccurate reporting are monitored by exchange market regulation divisions and can lead to significant disciplinary sanctions.[10]

Recordkeeping Issues

Parties to both block trades and EFRP transactions are subject to various recordkeeping obligations. For instance, CME Rule 538.H requires parties to an EFRP transaction to maintain all records relevant to the exchange contract and the related position transaction, including order tickets, records customarily generated in accordance with relevant market practices, records reflecting payments between the parties and, where appropriate, transfer of title, as well as any other records required to be kept pursuant to CFTC recordkeeping rules.[11]

Prohibited Transitory EFRPs

Exchange rules generally require that EFRP transactions bear genuine economic risk. On that basis, exchanges prohibit "transitory" EFRPs, which occur when the execution of one EFRP is contingent upon the execution of another EFRP between the same parties (or the offset solely of one of the legs of the EFRP), resulting in the offset of the related positions without incurrence of material market risk. However, CME Rule 538.K does permit immediately offsetting exchange-for-physical transactions in foreign currency futures, because the offsetting physical transaction is not contingent on the EFP in any way. If the futures leg of an immediately offsetting EFP in foreign currency is not accepted for clearing, the futures transaction is void and the counterparties would be left with the stand-alone physical transaction.[12]

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[7] See, e.g., CME Block Trade MRAN at paragraph 12; IFUS Block Trade FAQ at Q. 22.

[8] See CME EFRP MRAN at Q. 11; IFUS EFRP FAQ at Q. 5; *but see* IFEU Guidance on EFR, EFS and EFRPs at section 3 (prescribing specific pricing parameters for related positions and stating that "the price of the futures leg must represent a fair market value"); *and* CFE Regulatory Circular 20-003 ("Related positions must have a high degree of price correlation to the underlying of the Contract transaction so that the Contract transaction would serve as an appropriate hedge for the Related Position").

[9] See CME Block Trade MRAN, section 7; IFUS Block Trade FAQ at Q. 9; IFEU Block Trade Policy, Tables 1, 2 and 3; CFE Regulatory Circular RG18-018, p. 3.

[10] See, e.g., COMEX 17-0821-BC (available here) (COMEX disciplinary notice citing respondent for "a continuous pattern of inaccurately reporting block trades and reporting block trades late to the Exchange" and imposing an $85,000 fine.

[11] See CME EFRP MRAN at Q. 19; IFUS FAQ on EFRPs at Q. 19; IFEU Guidance on EFR, EFS and EFRPs, at section 3; CFE Rule 414(g).

[12] See CME EFRP MRAN at Q. 27; see also IFUS FAQ on EFRPs at Q. 14.

Analogously, IFEU permits exchange-for-swap transactions where the original underlying swap leg is offset or cancelled by a back-to-back swap and then replaced by a futures position as part of the same strategy. Each swap leg, however, must be able to stand alone if executed singly, and must bear genuine economic risk.[13]

Exchanges will consider the length of time between the offsetting related physical or OTC transaction and the EFRP in determining whether a transaction is transitory; but the primary consideration is determining whether the offsetting cash or OTC transaction can stand on its own as an independent transaction exposed to market risk.[14]

Enforcement Trends

When utilizing instruments such as block trades and EFRPs, pre-execution communications (subject to some restrictions in the case of block trades) are permitted, but such communications must be recorded and retained. Retention of these communications has been an area of active enforcement for the CFTC as well as other regulators, giving rise to several notable cases.

Unapproved Communication Platforms

In 2021 the CFTC settled charges against an FCM and its affiliate swap dealers for an alleged failure to maintain, preserve, and produce records, and failing to diligently supervise such recordkeeping. Respondents were cited for purportedly failing to supervise employee (and supervisory) use of personal text messages and social media platforms not approved under respondents' own compliance policies to engage in business-related communications. The CFTC found widespread violations of the firm's communication and record keeping policies. In addition to the alleged pervasive violative conduct, the CFTC claimed that the firm did not completely and promptly respond to the CFTC's subpoenas. This resulted in an agreed civil monetary penalty of $75 million for recordkeeping and supervision violations.[15]

Audio Recordings or Oral Pre-Trade Communications

In another recent enforcement action, the CFTC settled with a swap dealer for purportedly failing to maintain audio recordings. As a result of alleged failures in the firm's audio retention systems, over one thousand hours of audio recordings were deleted. In this instance, the firm detected the issue and self-reported the error to the Division of Enforcement. The firm's self-reporting, cooperation and remediation caused the CFTC to substantially reduce the civil monetary penalty imposed on the firm.[16]

Failure to Supervise

Failures in required recordkeeping can also raise an enforcement inference of failure to supervise. In 2020 the CFTC settled with a swap dealer for failures in its audio recording preservation system. The Division of Enforcement sent a subpoena to the firm, in response to which the firm represented that it would be preserving its audio recordings. However, subsequently, the firm purportedly ended up deleting over a million audio recordings over a month-long period, including recordings that were directly related to the scope of the subpoena. This led to a civil monetary penalty of $4.5 million for failure to diligently supervise the operation of the audio preservation system.[17]

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13 IFEU Guidance on EFR, EFS and EFRP, at section 3.

14 CME EFRP MRAN at Q. 14; IFUS EFRP FAQ at Q. 13.

15 *See* CFTC Release No. 8470-21, December 17, 2021 (available here).

16 *See* CFTC Release No. 8448-21, October 14, 2021 (available here).

17 *See* CFTC Release No. 8257-20, September 28, 2020 (available here).

While there are many lessons to be learned from these cases, one thing is clear: enacting a system that complies with the rules is not enough. In addition, critically, firms must periodically test their systems to ensure that they are effective, and also must ensure that written procedures adequately cover each relevant exchange's rules, and that relevant staff are regularly trained on such matters.[18]

Pre-Hedging: Dos and Don'ts

Pre-hedging is the management of risk associated with anticipated customer orders; the dealer's objective in pre-hedging is to control market risk associated with standing on the other side of the customer. In the context of one-way RFQs, where a participant requests a firm quote on a specified transaction from one or more liquidity providers, pre-hedging consists of any trading activity that takes place between the time that the participant requests the firm quote and the time it accepts or rejects the quote.[19] A major concern surrounding pre-hedging is market manipulation and fraud (e.g., front-running). Because pre-hedging is used to manage risk for orders that are large relative to the market's available liquidity, it has the potential to have a substantial impact on the market.[20] Before engaging in pre-hedging, market participants should consider current market conditions as well as the nature of the pre-hedge transaction and the effect such transaction may have on the market.

Principal counterparties to a potential block trade in futures are permitted to engage in pre-hedging of a position that they, in good faith, believe will result from the consummation of the block trade.[21] Prior to an October 2016 guidance update, pre-hedging had been expressly prohibited by CME rules. While pre-hedging is now permitted for principal counterparties, intermediaries or parties acting in an agency capacity with an express or implied duty to a customer are still prohibited from pre-hedging. Such intermediaries or agents in a potential block trade must wait for the consummation of the transaction to hedge or offset the position established by the block trade.[22]

When engaging in a block trade, whether in a principal or agent capacity, it is important to make clear each counterparty's respective roles. Using language that suggests an agency capacity may give rise to an implied duty, and thus make pre-hedging impermissible. Representations by a party that they will "work an order" on behalf of a counterparty, or block trade negotiations where the price of the block trade is tied to the price of the party's pre-hedging activity plus a "markup" or "basis" may be viewed to imply that such agency duties are owed to the counterparty. In such scenarios, pre-hedging is prohibited.

Representations by a principal in the negotiation of a block trade that the party is intending to act as a principal is sufficient proof there are no agency duties (express or implied) owed to the counterparty provided that such representations are made prior to engaging in any pre-hedging activity. For example, disclosures in the header/footer of a party's instant message communications advising that the party is acting principally and owes no agency duties to the counterparty would suffice in lieu of direct communications during the negotiation. Alternatively, such disclosures could be made on recorded phone lines or sent via email prior to the principal engaging in pre-hedging activity related to the block trade negotiation.[23]

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[18] Evidence of attendance at such training sessions should be retained in the ordinary course.

[19] Global Foreign Exchange Committee, Draft Guidance Paper 1: Pre-Hedging. May 2021 (available here).

[20] Global Foreign Exchange Committee, Draft Guidance Paper 1: Pre-Hedging. May 2021 (available here).

[21] CME Block Trade MRAN at 11(c); IFUS Block Trade FAQ at Q. 24; CFE Rule 415(p). Under IFEU rules, however, pre-hedging is prohibited. See IFEU Block Trade Policy ("Members are not permitted to enter into a transaction for their own benefit, which is transacted on the basis of and ahead of an order (including an order relating to a bid) which it, or an associate, is to carry out with or for another person, which takes advantage of the anticipated impact of the order on the market.")

[22] CME Group, Block Trades- Pre-Hedging Course (available here).

[23] See COMEX 19-1158-BC (available here).

Market Disruption Cases: A Regulator's Perspective

In recent years, spoofing has emerged as a primary focus of the CFTC's enforcement activity against market disruption.[24] Spoofing is specifically defined under section 4c(a)(5)(C) of the Commodity Exchange Act. A spoofing violation occurs when a trader intends to cancel a bid or offer before execution. "Spoofing" includes, but is not limited to: (i) submitting or cancelling bids or offers to overload the quotation system of an exchange's order book; (ii) submitting or cancelling bids or offers to delay another person's execution of trades; (iii) submitting or cancelling multiple bids or offers to create an appearance of false market depth; and (iv) submitting or canceling bids or offers with intent to create artificial price movements upwards or downwards.

A spoofing violation requires a market participant to act with some degree of intent, or scienter, beyond recklessness.[25] However, not all market disruption cases require a showing of intent. Indeed, a trader may only harbor commercially legitimate intent, and nevertheless be deemed liable for disruptive conduct, based solely on market impact of the trade.

In 2017, for example, CME and CBOT jointly settled disruptive trading charges with a member firm arising from the way the firm liquidated futures positions of its customers that were under-margined. According to the exchanges, on multiple dates between October 2014 and March 2015, the firm employed a liquidation algorithm that automatically entered market orders for the entire amount of an under-margined customer's positions. It did so, said the exchanges, without considering market conditions. As a result, claimed the exchanges, on at least three occasions on the CBOT and two occasions on the CME, the liquidation caused "significant price movements."[26]

Derived Blocks

A derived block is a block trade entered into by a party eligible to engage in block trades, in an eligible contract, for which the price and quantity are based on hedging transactions entered into by a dealer after the other terms of the trade have been agreed to, but before it is submitted to the exchange. Currently only CME is offering derived block functionality for eligible contracts.[27]

Ineligibility of Exchange-Traded Contracts to be the Related Position Component of an EFRP

Exchange rules prohibit EFRPs in which the related position is an exchange-traded or SEF-traded futures contract, option or swap or a swap executed pursuant to the rules of a SEF.[28] This condition can seem arbitrary to market participants, who have struggled to understand why the execution method for an instrument should be tied to a restriction on its availability to a risk management strategy. Indeed a swap that is perfectly eligible to be the related position of an EFRP can become ineligible simply by virtue of being processed through a SEF; market participants must be vigilant about what happens after the trade where they wish to use it in an EFRP.

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[24] CFTC FY 2020 Division of Enforcement Annual Report at 5 (December 2020) (available here).

[25] See CFTC's Interpretive Guidance and Policy Statement on Disruptive Practices ("Because CEA section 4c(a)(5)(C) requires that a person intend to cancel a bid or offer before execution, the Commission believes that reckless trading, practices, or conduct will not constitute a "spoofing" violation.") (available here).

[26] See CME Disciplinary Notice 15-0158-BC (March 20, 2017) (available here); and see Gary DeWaal's commentary on the case (available here).

[27] Stephen Morris, CME Derived Blocks - a new way to price block trades on certain CME and CBOT Security Index Futures, Lexology (available here); see also CME Group, Equity Index Derived Blocks (available here).

[28] CME EFRP MRAN at Q. 3 and Q. 18; IFUS FAQ on EFRPs at Q. 1 and Q. 7; IFEU Guidance on EFS, EFR and EFRPs at section 2 (specifying the specific types of permitted related positions); CFE Regulatory Circular 20-003 at 2.

Non-“Incidental Matching of Buy and Sell Orders”: How Much Is Too Much?

Exchange rules prohibit the buying or selling in the same product and expiration month (and for put or call options, the same strike price) where the market participant knows or reasonably should know that the purpose of the orders is to avoid taking a bona fide market position exposed to market risk.[29] This practice of buying and selling the same product to avoid exposure to risk is known as wash trading and has been at the center of much regulatory discussion.

A wash trade violation has two elements: (1) a matching buy and sell order or accounts with the same beneficial owner; and (2) intent that the orders match (which may be inferred from evidence of prearrangement or from evidence that the orders were structured, entered or executed in a manner that the parties knew, or reasonably should have known, would produce a wash result). The unintentional and incidental matching of buy and sell orders entered by an individual trader on the electronic platform generally will not be considered a violation. However, if such self-matching occurs on more than an incidental basis in the context of the trader’s activity or in the context of the particular market’s activity, such trades may be deemed to violate the prohibition on wash trades.[30]

Exchanges have not typically provided numerical safe-harbors to guide market participants when wash trades might be regarded as incidental or not incidental. As a result, the line defining “more than an incidental basis” is not a specific quantity or percentage; however, as a Supreme Court Justice once noted regarding a certain kind of pornography, exchange regulators know it when they see it.[31]

All market participants are required to implement procedures to protect against wash trading. To that end, exchanges offer self-trade prevention functionality that can assist participants to prevent incidental wash sales. Although exchanges do not mandate adoption of such functionality, the failure to use it combined with more than “incidental” self-matching, would constitute bad facts in an exchange investigation.

[29] See CME Rule 534; IFUS Rule 4.02; IFEU Rule E.2.2A; CFE Rule 616.

[30] See CME Wash Trade MRAN (available here).

[31] *Jacobellis v. Ohio*, 378 U.S. 184, 197 (1964) (Stewart, J. concurring).

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