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EFRPs and Block Trades: Where Did They Come From And Where Are They Going?

BY LISA DUNSKY

Lisa Dunsky is a partner in the Financial Services group at Katten Muchin Rosenman LLP in Chicago. She can be reached at lisa.dunsky@kattenlaw.com.

I. Introduction

As a result of regulatory changes brought about by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), transactions known as exchanges for related positions ("EFRPs") and block trades have become the subject of increased scrutiny and attention. Each is a type of privately negotiated futures transaction, executed away from the centralized marketplace, but subject to the rules of an exchange. EFRPs and block trades generally are limited to sophisticated market participants,[1] and must be reported to the relevant exchange within a prescribed time period, which is usually shorter for block trades.

In an EFRP, futures contracts are exchanged for an economically offsetting position in a related cash commodity or OTC derivative.[2] EFRPs may include an exchange for physical or cash commodities ("EFP"), an exchange for swaps ("EFS"), an exchange of over-the-counter ("OTC") options for exchange-traded options ("EOO"), or an exchange for risk ("EFR", a term that may be used to refer to EFS or EOO transactions). Historically, EFPs provided flexibility to commercial market users to make or take delivery on their futures commitments outside the standardized exchange delivery system (allowing, for example, delivery at different locations and of different qualities of product than those specified under exchange rules). Block trades do not involve an offsetting cash or OTC position but are subject to exchange rules that establish minimum "threshold" quantities and pricing requirements. Historically, a block trade was viewed as a mechanism for institutional traders to execute a large order at a single, unified price.

CONTINUED ON PAGE 4

Table of CONTENTS

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From the EDITOR

CFTC Staff Earns Its Pay

Former Commodity Futures Trading Commission Chairman Gary Gensler was a tough taskmaster. He required the staff of the CFTC to issue proposed rules, final rules, guidelines, exemptions, letters and advisories that create a highly regulated and transparent marketplace for swaps trading. Even if you disagree with the CFTC on substance—as we have seen the agency has been challenged in court on position limits, commodity pool and most recently cross-border issues—the CFTC has been the most proactive of the numerous regulators tasked with implementing the Dodd-Frank Act. The CFTC's lawyers and its other staff have been among the hardest working employees of any federal financial oversight agency.

Let's look at the evening of December 20, 2013. Due to the expiration of an exemptive order published on July 22, 2013, December 21, 2013 was a key compliance date for foreign-based CFTC-regulated swap dealers. On the evening of December 20, 2013, the CFTC approved substituted compliance determinations for swap dealers located in the European Union, Canada, Switzerland, Australia, Japan and Hong Kong with respect to entity-level requirements for swaps, such as having a chief compliance officer and implementing a risk management program. The CFTC also approved of substituted compliance determinations for certain swaps transaction-level requirements for the EU and Japan, including for CFTC-required swap trading relationship documentation. These determinations took a tremendous amount of study and drafting by many CFTC staffers.

CONTINUED ON PAGE 3

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The CFTC staff also issued no-action Letters 13-75 and 13-78, granting time-limited relief from certain internal business conduct, reporting and recordkeeping requirements for swap dealers located in these six jurisdictions. In between Letters 13-75 and 13-78, on the same day the CFTC staff issued Letter 13-76 granting time-limited relief for an Australian-trading platform from being required to register as a swap execution facility and Letter 13-77 on the applicability of oral recording requirements for commodity trading advisor members of swap execution facilities.

The CFTC was handed Title VII of the Dodd-Frank Act, requiring the agency to construct a new regime for a regulated swaps marketplace. Chairman Gensler embarked on a crusade to protect the U.S. financial system from a 2008-type meltdown with respect to derivatives. Mr. Gensler's colleagues on the CFTC's staff had the formidable task of creating a new derivatives regulatory structure, taking into consideration the global nature of the swaps market and the requests and demands of foreign country regulators and the industry. For those of us in the private sector who were yelling at our computers on the night of December 20 when the avalanche of substituted compliance documents began streaming across our screens, we also have to admit that our colleagues at the CFTC accomplished a great deal. James Brown was the hardest working man in show business, but the CFTC staff were the hardest working public servants in Washington in 2013. But please, can they stop issuing these tomes on Friday nights, they are ruining our weekends!

MSS

Clarification: *We regret the omission of the firm affiliation of Messrs. Allan Yip and Mark O'Brien, whose article entitled, "ISDA/FOA Client Cleared OTC Derivatives Addendum: An Overview," appeared in the November issue. Messrs. Yip and O'Brien are partner and managing associate, respectively, of Simmons & Simmons.*

CONTINUED FROM PAGE 1

EFRPs and block trades are exceptions to the general prohibition against noncompetitive and prearranged transactions in U.S. futures markets. These and certain other types of off-exchange or "ex pit" transactions—which are distinguished from transactions executed via an electronic trading platform with a central limit order book or via traditional open outcry—currently are permitted in accordance with Commodity Futures Trading Commission ("CFTC") Regulation 1.38.[3] That Regulation states, in relevant part:

> **§ 1.38 Execution of transactions.**
>
> **(a)** ***Competitive execution required; exceptions*****. All purchases and sales of any commodity for future delivery, and of any commodity option, on or subject to the rules of a contract market shall be executed openly and competitively by open outcry or posting of bids and offers or by other equally open and competitive methods, in the trading pit or ring or similar place provided by the contract market, during the regular hours prescribed by the contract market for trading in such commodity or commodity option:** ***Provided, however*****, That this requirement shall not apply to transactions which are executed non-competitively in accordance with written rules of the contract market which have been submitted to and approved by the Commission, specifically providing for the non-competitive execution of such transactions.**

17 C.F.R. § 1.38(a).

In addition to being utilized for commercial purposes or to execute large orders at a single price, over the years, EFRPs and block trades have become tools for exchanges to respond to market developments, launch new products and build open interest in less liquid markets. For certain instruments, what has been traditionally viewed as a limited exception for off-exchange transactions is now the rule. As discussed below, the CFTC has been an active observer of these developments and has now placed EFRPs and block trades in the regulatory crosshairs as it struggles to balance price discovery in a centralized market with transparency and other important benefits stemming from flexible rules permitting wider use of off-exchange transactions.

II. Regulatory History

(a) Regulation 1.38

Before passage of the Commodity Exchange Act ("CEA") in 1936, EFPs were permitted under exchange rules as exceptions to the general requirement of execution in the trading pit.[4] Regulation 1.38 originally was adopted in 1937 as Section 38 of the regulations promulgated under the CEA to allow EFPs, transfer trades and office trades in accordance with "written rules of a board of trade…."[5] In 1953, what was by then Regulation 1.38 was amended to require competitive execution of all trades except for those executed in accordance with exchange rules providing for noncompetitive execution.[6] The Regulation was subsequently amended in 1966,[7] 1976,[8] and most recently in 1981.[9]

(b) 1987 EFP Report

By 1985, substantially increased utilization of EFPs by market participants prompted the CFTC to launch a study of EFP practices. EFP volume had increased by as much as 10-fold between 1983 and 1986, although EFPs constituted no more than 25% of the volume of any market.[10] In 1987, the CFTC's then-Division of Trading and Markets issued its *Report on Exchanges of Futures for Physicals* (the "1987 EFP Report" or the "Report"). The Report focused on EFPs in stock index and interest rate futures on the Chicago Mercantile Exchange ("CME") and the Chicago Board of Trade ("CBOT"); gold on the Commodity Exchange ("COMEX"); grains on CBOT; crude oil on the New York Mercantile Exchange ("NYMEX"); and sugar and cocoa on the Coffee, Sugar & Cocoa Exchange (now ICE Futures US).

As the Report emphasized, "EFPs are limited to transactions that have been executed in accordance with exchange rules approved by the Commission. Thus, the responsibility for regulating EFPs lies in the first instance with the exchang-

es."[11] At that time, exchange rules "generally provide[d] little guidance and place[d] few limits on the permissible scope of EFPs."[12] Yet the role of EFPs in futures markets was expanding:

> **EFPs traditionally served an important function for commercial market users by providing a means of pricing a cash transaction or of making or taking delivery on their futures commitments outside the normal exchange delivery system, allowing them to offset positions through a privately negotiated transaction…. More recently, EFPs have been used by non-commercial traders in some markets, such as precious metals, in transactions such as arbitrage, and in trading to enter or exit the futures market outside of regular trading hours.[13]**

The Report recognized that EFP practices were evolving to meet industry needs as the nature of futures markets changed, and urged adoption of a "flexible approach" to regulation.[14] It noted, however, that "the potential for abuse is clearly present, most notably with EFPs involving transitory ownership of the cash commodity (such as those which take place in the gold and currency markets)."[15] Thus, the Report suggested that regulators evaluate the "bona fides" of EFPs, with a predominant consideration being "whether the cash transfer can stand on its own as a commercially appropriate transaction, with no obligation on either party to carry out the EFP."[16] In other words, the Report contended that execution of the cash transaction should not be contingent upon execution of the EFP.

So that the exchanges and the CFTC could better assess the bona fides of EFP transactions, the Report recommended that CFTC regulations be amended to require that: (1) futures commission merchants ("FCMs") obtain from their customers documents evidencing the cash transactions associated with EFPs, in response to exchange or CFTC requests; (2) customers furnish the requested information to their FCMs, or directly to an exchange or the CFTC, upon request; and (3) exchanges be required to adopt rules requiring that their members provide such documents to the CFTC upon request.[17] CFTC Regulation 1.35 was amended pursuant to these recommendations,[18] and exchange rules now require clearing members and market participants to produce, upon request, documents relating to an EFP (and other types of EFRPs), including documents evidencing the non-futures component of the transaction.[19]

(c) 1998 Concept Release

Increased usage of ex-pit transactions in the years following publication of the 1987 EFP Report prompted the CFTC to issue a Concept Release in January 1998 to explore the possibility of "expanding the boundaries of permissible noncompetitive trading."[20] Recognizing that "carefully designed revisions to the regulatory structure governing noncompetitive transactions could have a procompetitive effect",[21] the CFTC requested comments on alternative transaction types that were not then permitted in futures markets, including EFS transactions (which had been proposed by NYMEX in response to the expanding use of swaps in energy markets) and block trades. The CFTC observed that futures exchanges had adopted special procedures for the execution of "large orders", and securities regulators had adopted rules permitting block trades.

The Concept Release noted that EFP activity had increased dramatically in financial futures, particularly in CME's foreign exchange ("FX") contracts. As explained in a comment letter in response to certain Dodd-Frank rulemaking proposals, this increased usage of EFPs was a reaction to developments in the FX markets:

> **CME's foreign exchange products were first introduced in 1972 and quickly matured into a successful open outcry market. In the early to mid 1990s, CME's foreign exchange market began to lose momentum as the interbank market became increasingly electronic. In the late 1990s, CME's open outcry volumes had declined and market users began to use EFP transactions in CME FX markets because they did**

not have access to prices in the interbank markets while trading in the pit at CME.[22]

The uptick in EFP activity prompted the CFTC to question whether standards for bona fide EFPs from the 1987 EFP Report "should be codified in the Commission's regulations and/or refined in any way."[23] The CFTC also requested comments on criteria for determining whether transitory EFPs were bona fide, and for identifying contingent EFPs, which it described as "an impermissible subset of transitory EFPs" in which the cash commodity transfer and the EFP "are not severable but are contingent upon each other."[24]

The CFTC received more than 60 comment letters, which essentially fell into two camps: (1) those who believed that "alternative execution procedures should be implemented in order to alleviate current difficulties faced by institutional market participants in executing large futures and options orders"; and (2) those who believed that "alternative execution procedures would divert order flow away from the centralized, competitive marketplace, thereby reducing liquidity and jeopardizing the price discovery and hedging functions of the futures markets."[25] Faced with this lack of consensus, in June 1999, the CFTC issued an advisory stating that it would continue to allow the exchanges to "retain discretion whether to permit alternative execution procedures", which the CFTC would evaluate "on a case-by-case basis."[26] The CFTC advised that, in making rule submissions in relation to permissible non-competitive transactions:

… a contract market should discuss the impact of its proposal on the usefulness of the contract market as a vehicle for price discovery and risk transfer, whether its proposal represents the least anticompetitive means of achieving its objective, whether the proposed transactions fulfill some need of market participants that traditional open outcry cannot fulfill as well, and whether the transactions are structured in such a way as to complement the competitive market.[27]

(d) The Commodity Futures Modernization Act of 2000

Against this background, in December 2000, the Commodity Futures Modernization Act ("CFMA") was enacted. The CFMA "provided much-needed legal certainty to the burgeoning over-the-counter markets by creating statutory exclusions and exemptions from regulation for swaps and other OTC derivatives."[28] Derivatives clearing organizations ("DCOs") were permitted to clear transactions executed in OTC markets, in furtherance of the CFMA's stated purpose "to reduce systemic risk and provide greater stability to markets during times of market disorder by allowing the clearing of transactions in [OTC] derivatives through appropriately regulated clearing organizations."[29]

The CFMA created flexible, high-level "core principles" for futures exchanges or designated contract markets ("DCMs").[30] This included Core Principle 9 (Execution of Transactions), which required DCMs to provide a "competitive, open, and efficient market and mechanism for executing transactions." In addition, under Core Principle 3 (Fair and Equitable Trading): (a) DCM rules could authorize an exchange of futures for cash commodities, for swaps, or in connection with a cash commodity transaction; and (b) an FCM, acting as principal or agent, could enter into or confirm the execution of a contract for the purchase or sale of a commodity for future delivery if the contract is reported, recorded or cleared in accordance with the rules of a DCM or DCO.

This set the stage for DCMs to adopt rules permitting EFS and EOO transactions and block trades. The CFTC did not adopt any guidance or acceptable practices with regard to EFRPs, and its guidance with respect to block trades stated only that DCMs "should ensure that the block trading does not operate in a manner that compromises the integrity of prices or price discovery on the relevant market."[31] Block trades soon became a mechanism not only to execute a large futures or-

der at a single price, but to build liquidity in new products. For example, on OneChicago (the only domestic security futures exchange, launched in November 2002), block trades quickly accounted for more than 50 percent of volume.[32]

(e) Energy Derivatives Markets Post-Enron

Significantly, the flexible regulatory scheme provided by the CFMA helped energy markets emerge from the bankruptcy of Enron and the consequent implosion of the energy merchant sector due to counterparty credit concerns in OTC energy markets. In 2002, Intercontinental-Exchange ("ICE") and NYMEX began offering clearing services for OTC energy derivatives. The energy contracts listed by ICE, which operated an exempt commercial market,[33] were cleared as swaps (initially by the London Clearing House, and later by ICE Clear Europe).[34]

At NYMEX—which, at that time, was dually registered with the CFTC as a DCO and a DCM—OTC swaps or options were brought into NYMEX for clearing through EFS or EOO transactions.[35] Once cleared, those contracts (sometimes referred to as "ClearPort" contracts, referencing the platform used for reporting off-exchange transactions to NYMEX for clearing) were treated as futures or options on futures. The "ClearPort model" has been chiefly employed for less liquid contracts in the energy markets, while a large percentage of volume in NYMEX's benchmark WTI crude oil and Henry Hub natural gas contracts continued to be competitively executed.

NYMEX later extended its EFS/EOO model to metals contracts listed on COMEX, which NYMEX had acquired in 1994. NYMEX and COMEX rules allowed EFS and EOO transactions to be done on a transitory basis and did not require parties to have a master swap agreement or other "long form" agreement in place. Rather, pursuant to exchange rules, parties to an EFS or EOO could obtain a confirmation statement from a third-party broker to evidence the OTC (i.e., non-futures) leg of the transaction.[36] A template confirm published by NYMEX for these purposes stated: "In the event the [OTC derivative] Transaction is not ultimately accepted by NYMEX, the counterparties agree that the Transaction will be null and void and of no legal effect."[37] In other words, an EFS or EOO transaction on NYMEX and COMEX could be done as a single, contingent transaction.

(f) July 2004 Rulemaking Proposal

By 2004, the CFTC believed it had gained sufficient administrative experience to propose amendments to rules implementing the CFMA. One source of experience was the CFTC's rule enforcement reviews ("RERs"), conducted by the Division of Market Oversight ("DMO"), which included reviews of DCMs' enforcement of rules for EFRPs and block trades.[38] In July 2004, the CFTC issued a notice of proposed rulemaking (the "July 2004 NPRM") to amend Regulation 1.38 and acceptable practices for block trades and EFRPs under DCM Core Principle 9.[39]

As proposed, amended Regulation 1.38 would identify different types of "trades off the centralized market" and provide for self-certification of DCM rules allowing such transactions. The CFTC also proposed to "provide more detail" in its guidance on DCM block trade rules.[40] Among other things, the proposed guidance provided for an acceptable minimum block size "no smaller than the customary size of large transactions in any relevant markets,"[41] which generally was defined as a level larger than 90% of the transactions in the relevant market. In addition, the CFTC proposed to include in the DCM Core Principle 9 acceptable practices a definition of a "bona fide" EFP (based upon the 1987 EFP Report). Comment letters criticized the arbitrary nature of the 90% threshold and contended that the proposed guidance would stifle innovation with respect to transactions executed outside of the centralized market.[42]

(g) 2005-2006 Enhanced Reporting Requirements

As use of EFRPs and block trades continued to increase, the CFTC revised its reporting requirements for such transactions. Prior to 2005, the CFTC's Part 16 reporting rules required ex-

changes to separately account for volumes attributable to EFP transactions, but not other types of EFRPs. Effective in January 2005, "[i]n order to recognize the growing use of" EFRPs, the CFTC revised its Part 16 rules to require exchanges to separately identify, report and publish for each contract the volume attributable to EFRPs.[43] Block trades, however, continued to be reported with other volume.

Effective in July 2006, "[t]o more comprehensively recognize the growing importance and use of off-centralized market transactions", the CFTC further revised its Part 16 rules to require exchanges to record and make publicly available the volume generated by block trades.[44] In adopting these revised rules, the CFTC stated:

> **The publication of a contract's total volume of trading, alongside the volume generated from exchanges of futures and block trades, will enhance the ability of market participants and the general public to effectively analyze the determinants of market prices, the depth of market liquidity, and the utility of contracts as hedging and pricing tools.[45]**

(h) September 2008 Rulemaking Proposal

By March 2008, the monthly volume in NYMEX ClearPort contracts had grown to more than 9.5 million contracts, as compared to approximately 25,000 ClearPort contracts cleared in August 2002.[46] As the CFTC observed, although ClearPort contracts were offered for trading, NYMEX had "only de minimis volume in trades executed on ClearPort Trading. Most trades in products cleared through ClearPort Clearing are executed off the exchange on a bilateral, over-the-counter basis."[47]

By September 2008, the CFTC had "learned more about the common practices involved in transactions done off the centralized market from the comment letters received, from informal interviews with various entities in the futures industry, from DCM rule submissions, and from informal studies of trading data related to off-centralized market transactions."[48] Based on this "growing experience", the CFTC issued a new notice of proposed rulemaking (the "September 2008 NPRM") that was "substantively similar" to the July 2004 NPRM.[49] The September 2008 NPRM, however, backed away from the previously proposed 90% threshold for minimum block trade size, and instead maintained that "acceptable minimum block trade size should be a number larger than the size at which a single buy or sell order is customarily able to be filled in its entirety at a single price in that contract's centralized market."[50]

With respect to EFRPs, the September 2008 NPRM proposed Core Principle 9 guidance was intended to make clear that transitory EFRPs were permissible if each part of the transaction (i.e., the EFRP itself and the cash or OTC derivative transaction) was a standalone, bona fide transaction. It further provided that "[t]here must be no obligation on either party that the cash transaction will require the execution of a related EFP, or vice versa."[51] The proposed acceptable practices also required at least one leg of an EFRP to be priced at the prevailing market price. While commenters supported rejection of the 90% threshold for block trades, they found the proposed acceptable practices with respect to EFRP pricing to be unduly restrictive, and CME Group (which acquired NYMEX in 2008) urged the CFTC not to prohibit contingent EFRPs.[52]

III. The Dodd-Frank Act

Before the CFTC took final action with respect to the September 2008 NPRM, Congress initiated the legislative process that culminated in passage of Dodd-Frank in July 2010. Of particular relevance here, Dodd-Frank amended the CEA by revising the DCM core principles and giving the CFTC jurisdiction over swaps, swap dealers and major swap participants ("MSPs"). This launched extensive and often prescriptive rulemakings by the CFTC—a marked change from the principles-based approach under the CFMA—which further intensified the regulatory focus on EFRPs and block trades.

(a) DCM Core Principle 9

Title VII of Dodd-Frank amended the DCM core principles, located in Section 5 of the CEA. As amended, Core Principle 9 requires each DCM to "provide a competitive, open, and efficient market and mechanism for executing transactions *that protects the price discovery process of trading in the centralized market*…."[53] It further permits DCM rules to authorize off-exchange transactions "for bona fide business purposes."[54]

In December 2010, the CFTC proposed a complete overhaul of its Part 38 DCM regulations and related guidance and acceptable practices implementing the DCM core principles.[55] With regard to Core Principle 9, the CFTC proposed to eliminate Regulation 1.38 and adopt a series of highly prescriptive regulations. Proposed Regulation 38.502 (Minimum Centralized Market Trading Requirement) would require that at least 85 percent of the total volume of any contract listed on a DCM be traded on the centralized market (i.e., not executed off-exchange through EFRPs or block trades), as calculated over a 12-month period. If a contract failed that test (sometimes referred to as the "85% Rule"), the DCM would be required either to delist the contract and transfer the open positions in the contract to a swap execution facility ("SEF") or require market participants to liquidate their positions in the contract within 90 days.

Proposed Regulation 38.503 (Block Trades on Futures Contracts) would limit block trades to "large transactions" and require the block trade size for each listed contract to be certified to or approved by the CFTC.[56] In proposing this Regulation, the CFTC recognized that "the minimum size thresholds for block trades may change over time due to changes in sizes of trades in the centralized market and the market's volume and liquidity."[57] Thus, Regulation 38.503 would require DCMs to review block trade size on an annual basis. Proposed Regulation 38.505 (Exchange of Derivatives for Related Position) would essentially codify the proposed acceptable practices for EFRPs from the September 2008 NPRM, and would require EFRPs to be reported to the relevant exchange within five minutes of execution.[58]

The CFTC's proposed rules implementing Core Principle 9 have been the subject of extensive comments, the majority of which staunchly oppose the CFTC's approach. Commenters have characterized the 85% Rule as arbitrary, not required by Dodd-Frank, damaging to DCMs' ability to successfully develop new and innovative products, and a rule that would needlessly force existing contracts from DCMs to SEFs or onto OTC venues that lack transparency. As CME Group stated in 2011, particularly hard hit would be NYMEX's ClearPort contracts:

> **The 85% Rule would have the ultimate effect of moving at least 490 of our listed energy products off the NYMEX DCM and onto a SEF or other OTC market. The open interest for these products is approximately 36.6 million contracts. The overall transaction volume for these products during the first 6 months of 2011 was approximately 65 million; trading outside the centralized market accounted for 77% of that volume. This entire market would be forced outside the auspices of NYMEX as a result of the 85% Rule. Significantly, we believe that at least 350 contracts within this group would not be subject to the trading and clearing mandate [components of Dodd-Frank], which means these markets would be pushed into the OTC space. No regulatory or public benefit would be achieved by this result.[59]**

In May 2012, the CFTC approved rules implementing most of the revised DCM core principles.[60] Proposed rules implementing Core Principle 9 have not yet been finalized, however, and were the subject of a public roundtable on June 5, 2012. Much of the discussion at the roundtable focused on applying Core Principle 9's requirement of a "competitive, open and efficient market and mechanism that protects the price discovery process of trading on the centralized market" to markets where off-exchange transactions have become the norm. One CFTC staff member summarized the issue as follows:

> **… the Commission has always viewed off-centralized market trading as an exception. [W]hat we're trying to get our head around is what happens when it's the rule, when all of the trading is off the centralized market? There is no pre-trade price transparency on the DCM.[61]**

Panelists at the roundtable stated that pre-trade price transparency is not a regulatory requirement, and suggested that DCMs may comply with Core Principle 9 by offering a centralized market and taking steps to foster central limit order book trading.

(b) Swap Regulation and "Futurization"

In addition to revising DCM core principles, Title VII of Dodd-Frank dramatically changed the landscape by amending Section 2 of the CEA to give the CFTC jurisdiction over swaps. As a result, the U.S. swaps market has arguably become one of the most highly regulated financial markets in the world. The CFTC has adopted extensive regulations with respect to the clearing and trading of swaps, along with registration, reporting, business conduct, capital and other requirements for swap dealers and MSPs.

Faced with increased costs and regulatory burdens associated with the CFTC-regulated swaps market, some segments of the market turned toward the more familiar and less costly futures regime. The concept of "futurizing" swaps became a particular focus of attention in July 2012, when ICE announced plans to transition its cleared energy swaps to futures products listed on ICE Futures US and ICE Futures Europe. In mid-October 2012, when many CFTC swap regulations took effect, ICE announced that it had completed the transition of its energy swaps into futures contracts, "based upon feedback from customers seeking the regulatory certainty of futures markets amid the continued evolution of new swaps rules."[62] To facilitate this transition, ICE Futures US adopted rules for block trades in energy products, with minimum quantity thresholds as low as one contract.[63]

Similarly, NYMEX needed to address regulatory issues arising from EFS and EOO transactions, the OTC leg of which could subject market participants to CFTC swap regulations even though such transactions are cleared as futures contracts. In September 2012, CME Group issued an open letter stating that they would "provid[e] new alternatives for customers who prefer the certainty of futures regulatory treatment throughout the contract cycle."[64] Like ICE, in order to preserve market participants' ability to engage in noncompetitive execution without becoming ensnared in burdensome CFTC swap regulations, NYMEX adopted block trade rules with minimum threshold quantities as low as one contract.

On January 31, 2013, the CFTC held a public roundtable on the "futurization" of swaps. Chairman Gensler opened the meeting by emphasizing his view that it is "critical that we preserve the pre-trade price transparency that has been a core of the futures marketplace, and in that context I'm looking forward to hearing from panelists today about recent actions by the exchanges to lower their minimum block sizes for certain energy futures."[65] Commissioner O'Malia commented that the CFTC "had always kind of viewed blocks meaning … transactions that are large relative to something, usually relative to trading on a centralized market," and asked whether block trades had taken on another meaning, "as illiquid or something really not large."[66]

In response, panel members observed that it is not a "one size fits all equation",[67] and that instruments with less liquidity merit lower block size thresholds.[68] Panelists urged the CFTC to work with DCMs to employ a flexible approach that would enable trading in less liquid instruments to migrate to the centralized marketplace over time rather than adopting a rule that threatens to delist futures contracts or convert them to swaps, which "would negatively impact liquidity in a major way."[69]

IV. New Environment for Exchange EFRP Rules

(a) CFTC Rule Enforcement Reviews

While market participants await the CFTC's final rules implementing DCM Core Principle 9, the CFTC's Division of Enforcement has launched a series of inquiries and cases involving EFRP transactions.[70] Furthermore, DMO released several RERs in 2013 that are critical of exchanges' monitoring of EFRP transactions. For CME and CBOT, during DMO's one-year review period (November 2010 through October 2011), the exchanges had a combined total of approximately 484,000 EFRP transactions, and their Market Surveillance group opened fewer than 20 cases involving EFRPs. The CFTC found the exchanges' surveillance of the bona fides of EFRP transactions to be deficient:

> **[DMO] finds that the Exchanges have an inadequate program for ensuring that parties to an EFRP transaction maintain relevant documents pursuant to CME and CBOT Rule 538.H's documentation requirements and, accordingly, for verifying the bona fides of a sufficiently large, strategically selected sample of EFRPs. An improved and robust program is necessary both to uncover non-bona fide EFRPs as well as to deter parties from entering into and clearing firms from processing non-bona fide EFRPs.[71]**

The RER contains several "recommendations" for CME and CBOT with regard to surveillance of EFRP transactions:

> **Market Surveillance should request documentation for and verify the bona fides of multiple EFRP transactions including all EFRP types … across every product category at least once every calendar year for every carrying clearing member firm that clears EFRPs on the Exchanges. While Market Surveillance may utilize a degree of randomization in selecting the EFRPs for verification, Market Surveillance should choose the EFRPs with an eye to detecting potentially violative transactions. In addition to the examples of EFRPs that would warrant heightened scrutiny listed in [the Exchanges'] EFRP Manual, Market Surveillance should closely examine, among other things, EFRPs involving an unusually small number of contracts such as one-lot EFRPs, EFRPs just below the respective block size threshold, EFRPs between affiliates, parties that conduct a large number of EFRPs, and parties that execute offsetting EFRPs on the same day.[72]**

Similarly, an RER of ELX Futures, L.P. ("ELX") found that the National Futures Association ("NFA"), which is ELX's regulatory services provider, "should have a more robust process for reviewing more EFRP transactions to verify that the transactions are bona fide and the parties to an EFRP transaction maintain relevant documents pursuant to" ELX rules.[73] Notably, during DMO's one-year review period (June 2011 through May 2012), ELX had only 116 EFRP transactions, which represented less than one percent of contract volume.[74] Nevertheless, the RER states that "NFA should request documentation for and verify the bona fides of EFRP transactions from every Clearing Privilege Holder that clears EFRPs on [ELX] every calendar year, and depending on volume, review multiple EFRP transactions across every product category, as well as different types of EFRP transactions, if applicable."[75]

The relevance of the CFTC's surveillance recommendations is not limited to CME, CBOT and ELX. As the CFTC has explained, RERs are the "cornerstone" of the its oversight of DCMs: "Essentially, RER findings and recommendations communicate to the industry what [CFTC] staff believes are best practices for compliance and such recommendations typically are then adopted industry-wide as the standard form of compliance."[76] This bodes for a dramatically increased number of regulatory inquiries regarding EFRP transactions.[77]

(b) Proposed Amendments to CME Group Exchanges' Rule 538

In September 2013, the CME Group exchanges (CME, CBOT, NYMEX and COMEX) made a submission to the CFTC proposing significant amendments to their Rule 538 (Exchange for Related Positions). As initially proposed, the amended Rule would have prohibited transitory EFRPs in *all* products listed on the exchanges (including FX, metals and energy products, in which transitory EFRPs have historically been permitted). In addition, the proposed "FAQ" document accompanying amended Rule 538 would emphasize recordkeeping requirements for EFRP-related documents, noting that "Market Regulation may assess summary fines of up to $10,000 per offense against member or non-member firms for the failure to provide records in a complete or timely manner." The proposed "FAQ" would further advise that brokers that execute or clear EFRPs on behalf of customers (i) "are responsible for ensuring that their customers who execute EFRPs are fully informed regarding Exchange EFRP requirements", and (ii) "should establish, document and execute controls that are reasonably designed to prevent and detect execution of non-bona fide EFRPs."

Following the conclusion of a public comment period, the CME Group exchanges submitted to the CFTC in November 2013 a revised proposal to amend Rule 538. Under this proposal, new subpart K of Rule 538 would permit transitory EFPs in foreign currency futures, so that the parties would be permitted to immediately offset the cash-market component of the EFP. For such transactions, the exchanges would expect to see, among other things "confirmation statements issued by the bank/foreign exchange dealer party to the Transaction."[78] As stated in the currently proposed "FAQ" document, "[t]ransitory EFRs and EOOs in CME foreign exchange products are prohibited, as are transitory EFRPs in all other products listed on the CME Group Exchanges."

The "FAQ" document also states that a swap traded on or subject to the rules of a DCM or SEF "is ineligible to be the related position component of an EFR or EOO transaction " while a bilaterally negotiated swap that is "submitted for clearing only" may be utilized for the related position component. Several commenters criticized this proposed language and urged the CFTC not to approve the "FAQ" document unless the language is removed.[79] As one commenter observed, "[l]imiting the types of swaps eligible to be exchanged as part of an EFRP based solely on their execution method restricts the product and risk management choices available to market participants and may limit the development and evolution of DCM, SEF and OTC products."[80]

Regulatory developments in the coming weeks and months will likely include finalization of proposed revisions to CME Group exchanges' Rule 538, and issuance by the CFTC of final regulations for DCM Core Principle 9. All market participants involved in off-exchange transactions—whether as counterparties, executing brokers or clearing firms—will need to stay up to date on these developments and take appropriate steps to ensure an appropriate level of training, monitoring and supervision in connection with EFRPs and block trades.

END NOTES

1. Parties to exchange for swaps ("EFS") or exchange of options for options ("EOO") transactions must comply with Commodity Futures Trading Commission ("CFTC") regulatory requirements governing eligibility to transact the OTC component of the transaction. Because an exchange for physical ("EFP") transaction includes a cash market component, EFP transactions typically are transacted by commercial market participants that transact business in the relevant cash market. Exchange rules generally require parties engaging in block trades to be "eligible contract participants" as that term is defined in the Commodity Exchange Act ("CEA"), 7 U.S.C. § 1, et seq.
2. Exchange rules typically require that the associated related position must be comparable with respect to quantity, value or risk exposure with the exchange contract.
3. Before passage of the Commodity Futures Modernization Act of 2000 (the "CFMA"), Section 4c(a) of the CEA prohibited wash sales, fictitious sales and similar types of transactions, but provided that "[n]othing in this section shall be construed to prevent" EFPs, transfer trades or office trades "if made in accordance with board of trade rules applying to such

transactions and such rules shall have been approved by" the CFTC. Section 109 of the CFMA struck that version of Section 4c(a) and replaced it with a new provision that did not reference noncompetitive transactions.

4. CFTC, Division of Trading and Markets, *Report on Exchanges of Futures for Physicals* (Oct. 1, 1987) (the "1987 EFP Report"), at 1 (citation omitted).
5. 2 Fed. Reg. 1223, 1227 (July 16, 1937).
6. 18 Fed. Reg. 176 (Jan. 9, 1953).
7. 31 Fed. Reg. 5054 (Mar. 29, 1966) (amendments to clarify that Regulation 1.38 permits noncompetitive transactions).
8. 41 Fed. Reg. 3192 (Jan. 21, 1976) (amendments to require that rules of a contract market be approved by the CFTC).
9. 46 Fed. Reg. 54500 (Nov. 3, 1981) (amendments to require exchange-traded commodity options to be competitively executed).
10. 1987 EFP Report at 255-57.
11. *Id.* at 259.
12. *Id.* at 2.
13. *Id.* at 3.
14. *Id.* at 260.
15. The term "transitory" EFP generally refers to an EFP in which the cash leg involves an instantaneous or nearly instantaneous purchase and sale of the cash commodity, such that the parties acquire futures positions but end up with the same cash market position as they had before the EFP. Likewise, in a transitory EFS or EOO transaction, the OTC derivative leg involves an instantaneous or nearly instantaneous purchase and sale of the OTC derivative, such that the parties acquire futures (or options on futures) positions but end up with the same OTC derivative position as they had before the EFS or EOO. Transitory EFRPs have only been permitted in certain futures contracts, pursuant to applicable exchange rules.
16. 1987 EFP Report at 195. The Report suggested that transitory EFPs be "analyzed to ascertain whether there are integrally related cash and futures transactions, a transfer of ownership, separate parties, price correlation, justifiable pricing of the cash and futures legs, and the possession by the seller of the cash commodity." *Id.*
17. *Id.* at 261.
18. In its present form, Regulation 1.35 states, in relevant part:

    (c)(1) Futures commission merchants, introducing brokers, and members of designated contract markets and swap execution facilities. Upon request of the designated contract market or swap execution facility, the Commission, or the United States Department of Justice, each futures commission merchant, introducing broker, and member of a designated contract market or swap execution facility shall request from its customers and, upon receipt thereof, provide to the requesting body documentation of cash transactions underlying exchanges of futures or swaps for cash commodities or exchanges of futures or swaps in connection with cash commodity transactions.

    (2) Customers. Each customer of a futures commission merchant, introducing broker, or member of a designated contract market or swap execution facility shall create, retain, and produce upon request of the designated contract market or swap execution facility, the Commission, or the United States Department of Justice documentation of cash transactions underlying exchanges of futures or swaps for cash commodities or exchanges of futures or swaps in connection with cash commodity transactions.

    (3) Contract markets. Every contract market shall adopt rules which require its members to provide documentation of cash transactions underlying exchanges of futures for cash commodities or exchanges of futures in connection with cash commodity transactions upon request of the contract market.

    (4) Documentation. For the purposes of this paragraph (c), documentation means those documents customarily generated in accordance with cash market practices which demonstrate the existence and nature of the underlying cash transactions, including, but not limited to, contracts, confirmation statements, telex printouts, invoices, and warehouse receipts or other documents of title.
19. See, e.g., CME/CBOT/NYMEX Rule 538 (Exchange for Related Positions); ICE Futures US Rule 4.06 (Exchange for Related Position).
20. 63 Fed. Reg. 3708, 3710 (Jan. 26, 1998).
21. *Id*.
22. Memorandum from CME Group ("The CFTC's Proposed 85% Rule: Less Innovation, Higher Cost, Exporting Price Discovery and Increasing Systemic Risk") to the CFTC (Aug. 3, 2011), at 7.
23. 63 Fed. Reg. at 3711.
24. *Id*. at 3713.
25. 64 Fed. Reg. 31195, 31196 (June 10, 1999).
26. *Id*.
27. *Id*. at 31198.
28. CFTC, Report of the Oversight of Trading on Regulated Futures Exchanges and Exempt Commercial Markets (Oct. 2007), at 6.
29. Commodity Futures Modernization Act of 2000, § 2 (2000).

30. The terms "DCM" and "exchange" are used interchangeably throughout this article.
31. This guidance was adopted following passage of the CFMA as part of Appendix B to the CFTC's Part 38 regulations.
32. CFTC, Division of Market Oversight, Rule Enforcement Review of OneChicago (July 20, 2005), at 6.
33. Exempt commercial markets ("ECMs") were a type of electronic trading facility, permitted under the CFMA, on which "eligible commercial entities" could trade "exempt commodities" (primarily energy and metals) on a principal to principal basis. Dodd-Frank deleted the provisions of the CEA that provided for ECMs.
34. For U.S. customers, contracts traded on ICE Futures Europe (a foreign board of trade formerly known as the International Petroleum Exchange) were cleared in the "foreign futures" customer account class, in accordance with CFTC Regulation 30.7. OTC derivatives traded on the ICE ECM were commingled with those foreign futures contracts in the same customer origin, enabling ICE to offer customers significant capital benefits arising from portfolio margining.
35. In May 2002, NYMEX obtained an Order from the CFTC allowing NYMEX and its FCM clearing members to "commingle customer funds used to margin, secure, or guarantee transactions in futures contracts executed in the OTC markets and cleared by the NYMEX Clearing House with other funds held in segregated accounts maintained in accordance with Section 4d of the [CEA] and Commission Regulations thereunder." Commodity Futures Trading Commission, Order, Treatment of Funds Held in Connection with the Clearing of Over-the-Counter Products by The New York Mercantile Exchange (May 30, 2002). With all of its energy contracts clearing as futures or options on futures, even if executed as an EFS or EOO, NYMEX was also able to offer customers the significant capital benefits associated with portfolio margining.
36. See NYMEX Legacy Rules 6.21A and 6.21F; COMEX Legacy Rules 104.36A and 104.36B; NYMEX Notice to Members No. 07-413 (Aug. 21, 2007); NYMEX Notice to Members No. 214 (Apr. 17, 2008). In August 2008, CME Group Inc. (the parent company of CME and CBOT) acquired NYMEX Holdings, Inc. (the parent company of NYMEX and COMEX). Thereafter, NYMEX ClearPort became known as CME ClearPort, and NYMEX/COMEX rules allowing EFRP transactions were replaced with "harmonized" CME/CBOT/NYMEX Rule 538 (Exchange for Related Positions). See CME Group Market Regulation Advisory Notice RA0910-5 (Oct. 5, 2009); CME Group Market Regulation Advisory Notice RA1006-5 (June 11, 2010).
37. See NYMEX Notice to Members No. 07-413 (Aug. 21, 2007); NYMEX Notice to Members No. 214 (Apr. 17, 2008).
38. See, e.g., CFTC, Division of Market Oversight, Market Surveillance Rule Enforcement Review of the New York Mercantile Exchange (June 18, 2003) (reviewing NYMEX and COMEX enforcement of EFP and EFS rules from September 2001 to September 2002); CFTC, Division of Market Oversight, Market Surveillance Rule Enforcement Review of the Chicago Mercantile Exchange (July 30, 2003) (reviewing CME enforcement of EFP rules from September 2001 to September 2002); CFTC, Division of Market Oversight, Rule Enforcement Review of OneChicago (July 20, 2005) (reviewing OneChicago surveillance of block trades from August 2003 through December 2004)
39. 69 Fed. Reg. 39880 (July 1, 2004).
40. *Id*. at 39881.
41. *Id*. at 39885.
42. See, e.g., Letter from Chicago Mercantile Exchange Inc. (Craig Donohue, Chief Executive Officer) to the CFTC (Aug. 25, 2004); Letter from the Futures Industry Association (John Damgard, President) to the CFTC (Aug. 27, 2004).
43. 69 Fed. Reg. 76392, 76394 (Dec. 21, 2004).
44. 71 Fed. Reg. 37809, 37812 (July 3, 2006).
45. *Id.*
46. CFTC, Division of Market Oversight, Market Surveillance Rule Enforcement Review of the New York Mercantile Exchange (May 19, 2008), at 13.
47. *Id*. at 46, n.56.
48. 73 Fed. Reg. 54097, 54098 (Sept. 18, 2008).
49. *Id*. at 54098.
50. *Id*. at 54104.
51. *Id*. at 54101.
52. See, e.g., Letter from CME Group (Craig Donohue, Chief Executive Officer) to the CFTC (Jan. 5, 2009).
53. 7 U.S.C. § 7(d)(9)(A) (emphasis added).
54. 7 U.S.C. § 7(d)(9)(B).
55. 75 Fed. Reg. 80572 (Dec. 22, 2010).
56. Separately, the CFTC has adopted rules governing appropriate minimum block size for swaps, whether traded on a SEF or a DCM. 78 Fed. Reg. 42436 (July 16, 2013).
57. 75 Fed. Reg. at 80591.
58. Rather than EFRP, the term used in proposed Regulation 38.505 is "exchange of derivatives for related position", or EDRP.
59. Supra note 22, at 12.
60. 77 Fed. Reg. 36611 (June 19, 2012).

61. Transcript of Public Roundtable to Discuss Proposed Regulations Implementing Core Principle 9 for Designated Contract Markets (June 5, 2012), at 37.
62. Press Release, IntercontinentalExchange Inc., ICE Completes Transition of Energy Swap Futures (Oct. 16, 2012).
63. In October 2012, the CFTC issued an Order allowing ICE Clear Europe and its clearing members to hold both U.S. energy futures (listed by ICE Clear US) and foreign energy futures (listed by ICE Clear Europe) in the futures customer account origin, under Section 4d(a) of the CEA, for U.S. customers. The Order allows ICE to continue offering portfolio margining offsets to energy customers. Commodity Futures Trading Commission, Order, Treatment of Funds Held in Connection with Clearing by ICE Clear Europe Limited of Contracts Traded on ICE Futures Europe and ICE Futures US (Oct. 9, 2012).
64. Press Release, CME Group Inc., CME Group Issues An Open Letter To The Energy Market (Sept. 24, 2012).
65. Transcript of Public Roundtable on Futurization of Swaps (Jan. 31, 2013), at 19.
66. *Id*. at 229-30.
67. *Id*. at 233.
68. *Id*. at 201.
69. *Id*. at 110.
70. See, e.g., In the Matter of Morgan Stanley & Co., LLC, CFTC Docket No. 12-22 (June 5, 2012) (imposing a $5 million civil monetary penalty for allegedly executing, processing and reporting numerous EFRPs on CME and CBOT over an 18-month period that lacked a cash or OTC derivatives component); In the Matter of Hutchen, CFTC Docket No. 13-07 (Nov. 27, 2012) (imposing a $300,000 civil monetary penalty and a four-month registration suspension on the employee of Morgan Stanley & Co. who arranged the execution of the EFRPs "[i]n order to limit his clients' market risk, and to minimize the 'slippage' or price difference between the long and short positions purchased on their behalf").
71. CFTC, Division of Market Oversight, Rule Enforcement Review of the Chicago Mercantile Exchange and the Chicago Board of Trade (July 26, 2013), at 68.
72. *Id*. at 69-70.
73. CFTC, Division of Market Oversight, Rule Enforcement Review of ELX Futures, L.P. (Sept. 6, 2013), at 54.
74. *Id*. at 49.
75. *Id*. at 54.
76. 75 Fed. Reg. at 80574.
77. The CME Group exchanges have enhanced their surveillance and enforcement activities in relation to EFRP transactions. On November 27, 2013, CME issued a Notice of Disciplinary Action against a respondent that the Business Conduct Committee found had executed an Exchange for Risk transaction in a lumber futures contract "without an exchange of a corresponding OTC swap or other OTC instrument." The respondent was fined $15,000 for violating CME Rule 538. In the Matter of Koch Pulp & Paper Trading, LLC, CME 12-8850-BC.
78. As proposed, Rule 538.K would further require that, for FX EFPs between a bank/foreign exchange dealer and a CTA or other third-party account controller, "the cash side confirmation statement must identify, at a minimum, the name of the third party's Carry Clearing Member and the third party's account number (or other specific designation), but need not identify the third party by name." In comparison, the existing standard (under CME Group Market Regulation Advisory Notice RA1006-5) requires for such transactions that "the documentation must, at a minimum, uniquely identify the particular EFRP transaction and allow for it subsequent association with additional documentation which contains the identification of the third party by name or account number." The newly proposed language in Rule 538.K was criticized in a comment letter from the Futures Industry Association, which explained that when FX dealers execute transitory FX EFPs with a third-party account controller, they "typically do not know" the identity of the account controller's customers or their clearing members or account numbers. Letter from Futures Industry Association (Walter L. Lukken, President and Chief Executive Officer) to the CFTC (Dec. 6, 2013), at 2.
79. Letter from Citadel LLC (Adam C. Cooper, Senior Managing Director and Chief Legal Officer) to the CFTC (Dec. 6, 2013); Letter from TW SEF LLC (Jeffrey T. Letzler, Chief Compliance Officer) to the CFTC (Dec. 6, 2013).
80. Letter from Futures Industry Association (Walter L. Lukken, President and Chief Executive Officer) to the CFTC (Dec. 6, 2013), at 3-4.