

CFTC Proposes to Codify No-Action Relief for Swap Execution Facilities

March 9, 2020

On January 30, 2020, the CFTC **proposed a rule** (the **Proposal**) that largely codifies no-action relief the Commission previously issued related to the treatment of: (1) package transactions; (2) error trades; and (3) block trades on swap execution facilities (**SEFs**).

Execution of Package Transactions

The Proposal seeks to amend Part 37 of the CFTC regulations to allow greater flexibility in the execution of package transactions. “Package transaction” would be defined as a transaction consisting of at least two component transactions executed between at least two counterparties where:

- at least one component transaction is a Required Transaction—a swap required to be executed on a designated contract market (**DCM**) or a SEF’s order book or request-for-quote (**RFQ**) facility;¹
- execution of each component is contingent upon the execution of all other components; and
- the components are priced or quoted together as one economic transaction with simultaneous or near-simultaneous execution of all components.

The Proposal would allow a Required Transaction that is part of certain package transactions to be executed in a more flexible manner than other Required Transactions. Specifically, a Required Transaction that is executed as a component of any of the following three categories of package transactions could be executed on SEF through flexible methods of execution as if it were a Permitted Transaction—one not required to be executed on a DCM or SEF:

- (1) a package transaction where at least one of the components is a swap exclusively within the CFTC’s jurisdiction that is not subject to the clearing requirement (MAT/Non-MAT Uncleared);
- (2) a package transaction where at least one of the components is not a swap (MAT/Non-Swap Instrument);² or
- (3) a package transaction where at least one of the components is a swap not under the exclusive jurisdiction of the CFTC (MAT/Non-Exclusive CFTC Swap).

¹ Specifically, to qualify as a permissible method for the execution of Required Transactions, the RFQ facility must require requests of at least three unaffiliated market participants.

² For MAT/Non-Swap Instrument package transactions, the relief would not apply to a package transaction: (i) in which all non-swap components are U.S. Treasury securities; (ii) that is a MAT/futures package transaction; (iii) in which all other non-swap components are agency mortgage-backed securities; or (iv) that is a new issuance bond package transaction (as defined below).

The Proposal also would exempt from the trade execution requirement swap transactions that are executed as a component of a package transaction that also includes a new issuance bond. Such a new issuance bond package transactions must include at least one individual swap component that is a Required Transaction and at least one individual component that is a bond issued and sold in the primary market.

Error Trades

The Proposal would amend Part 37 to provide SEFs flexibility for determining their own error trade procedures and participant rules. “Error trade” would be defined as any trade executed on or subject to the rules of a SEF that contains an operational or clerical error, though it would exclude other types of errors.

SEFs would be permitted to allow market participants to correct operational or clerical errors by executing swap transactions using execution methods that do not satisfy the required execution methods for Required Transactions. The Proposal would require a SEF to maintain procedures and rules that allow for timely resolution of an error trade and which require market participants to provide prompt notice to the SEF of an error trade and the correcting and offsetting trade. The Proposal would apply to all error trades on SEFs, regardless whether the swap is submitted for clearing.

The relief differs for error trades that have been rejected for clearing versus those already accepted for clearing. For counterparties seeking to execute a new transaction with corrected terms after an executed swap is rejected by a derivatives clearing organization (**DCO**)—which would result in the executed trade being considered void *ab initio*—the Proposal would allow a SEF to accept a correcting swap that is a Required Transaction without execution through the methods otherwise required. For error trades that have been accepted for clearing by a DCO, the Proposal would require a SEF to permit counterparties to execute both an offsetting and correcting trade through any method of execution offered by the SEF.

The proposed timeframes for correcting trades also differ based upon whether an error trade was rejected or accepted for clearing.

- For an error trade rejected from clearing, the Proposal would require the SEF to submit the correcting trade for clearing to the registered or exempt DCO as soon as technologically practicable, but no later than one hour after notice of the rejection to the clearing members.
- For an error trade accepted for clearing, the SEF would have to submit an offsetting trade and a correction trade to the DCO as soon as technologically practicable, but no later than three days after the DCO accepted the error trade for clearing.

The Proposal provides greater flexibility to SEFs to determine error trade rules because it does not incorporate all of the conditions of the existing no-action relief. The Proposal also does not codify no-action relief from Rule 37.203(a), which prohibits pre-arranged trading for offsetting trades and correcting trades. The CFTC does not believe it is necessary to provide expressly such relief in the Proposal, because the SEF would have the flexibility to adopt trading practices that contain this relief.

Block Trades

Existing CFTC regulations define a swap “block trade” as a publicly reportable swap transaction that, *inter alia*, “occurs away” from the trading system or platform of the SEF or DCM.

The Proposal would amend the definition of “block trade” in Rule 43.2 to permit market participants to use a SEF’s non-order book trading system or platform for block trades while also allowing swap block trades to “occur[] away” from the SEF.

The current no-action relief allows swap block trades that are intended to be cleared (**ITBC**) to be executed on a SEF's non-order book trading system or platform. The Proposal, however, would also permit swap block trades that are not ITBC to be executed on SEF through non-order book methods of execution. This change, in turn, would enable pre-execution credit screening for block trades.

The CFTC notes that for swap block trades that are ITBC and executed on a SEF's non-order book trading system or platform, the proposed amended definition of "block trade" would permit futures commission merchants (**FCMs**) to conduct pre-execution credit screenings in accordance with Rule 1.73 and permit SEFs to facilitate those screenings.

Comments on the Proposal must be received on or before April 20, 2020. Because some of the issues addressed by this release were similarly addressed by the 2018 SEF Proposed Rule,³ the CFTC urges commenters to resubmit comments relevant to this Proposal while taking into consideration the independent facts and circumstances of this Proposal.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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³ Swap Execution Facilities and Trade Execution Requirement, 83 Fed. Reg. 61946 (Nov. 30, 2018) (the **2018 SEF Proposed Rule**).