

Client update

CFTC Extends and Expands No-Action Relief for Swaps Executed as Part of Certain Package Transactions

NEW YORK

Byungkwon Lim
blim@debevoise.com

Aaron J. Levy
ajlevy@debevoise.com

On November 10, 2014, the Division of Market Oversight (the “DMO”) of the Commodity Futures Trading Commission (the “CFTC”) issued a time-limited no-action letter (the “No-Action Letter”) extending and expanding its existing no-action relief (1) from the “Trade Execution Requirement” for swap counterparties and (2) from certain requirements relating to the “method of execution” and the offering of an “Order Book” for swap execution facilities (“SEFs”) and designated contract markets (“DCMs”), each with respect to certain interest rate and credit default swaps that have been made available to trade (“MAT”)¹ and are executed as part of certain specified categories of “package transactions.” The length and scope of the no-action relief provided varies by category of package transaction.

BACKGROUND

Section 2(h)(8) of the Commodity Exchange Act (the “CEA”) provides that swaps subject to the mandatory clearing requirement in section 2(h)(1) of the CEA must be executed on or pursuant to the rules of a DCM or SEF, unless no DCM or SEF makes such swaps available to trade or such swaps qualify for the clearing exception under section 2(h)(7) of the CEA (the “Trade Execution Requirement”).

Section 5(d)(9) of the CEA requires SEFs and DCMs to provide a competitive, open and efficient market and mechanism for executing transactions, and CFTC regulation 37.9 imposes a number of specific requirements relating to the permissible execution methods for transactions involving a swap that is subject to the Trade Execution Requirement (collectively, the “Method of Execution

¹ For more information on the Trade Execution Requirement and MAT determinations, see our client memorandums, “Mandatory Exchange-Trading for Swaps” <http://www.debevoise.com/clientupdate20131212a>, and “Swaps Subject to Mandatory Exchange-Trading: Update I” http://www.debevoise.com/insights/publications/2014/01/swaps-subject-to-mandatory-exchangetrading-updat__

Requirements”). In addition, CFTC regulation 37.3(a)(2) requires SEFs to offer an “Order Book”² (the “Minimum Trading Functionality Requirement”).

On February 10, 2014, the DMO issued a no-action letter providing relief for MAT swaps executed as part of any package transaction³ from the Trade Execution Requirement (for swap counterparties) and the Method of Execution Requirements (for SEFs and DCMs) until May 15, 2014.⁴ On May 1, 2014, the DMO issued another no-action letter granting relief for swaps executed as part of five specified categories of “package transactions.” The no-action relief for two of these categories of package transactions (U.S. Dollar Swap Spreads and MAT/Non-MAT Cleared Package Transactions)⁵ expired in June 2014; as such, the MAT swap components of these transactions must be executed on a SEF or DCM. The no-action relief for the other three categories (the “November 15 Packages”) expired on November 15, 2014, but has been extended by the No-Action Letter.

NO-ACTION LETTER

The No-Action Letter provides further time-limited no-action relief for swaps executed as part of the three November 15 Packages and three other categories of package transactions from the Trade Execution, Method of Execution and, in most cases, the Minimum Trading Functionality Requirements. The length and scope of the no-action relief provided varies by the following transaction categories. Where a package transaction is eligible for relief under more than one of the following categories, entities or counterparties may avail themselves of

² The term “Order Book” is defined in CFTC regulation 37.3(a)(3) as (1) an electronic trading facility (as defined in section 1a(16) of the CEA); (2) a trading facility (as defined in 1a(51) of the CEA); or (3) a trading system or platform in which all market participants in the trading system or platform have the ability to enter multiple bids and offers, observe or receive bids and offers entered by other market participants, and transact on such bids and offers.

³ “Package transactions” are defined as transactions involving two or more instruments: (1) that are executed between two or more counterparties, (2) that are priced or quoted as one economic transaction with simultaneous execution of all components, (3) that have at least one component that is a swap that is subject to the trade execution requirement and (4) where the execution of each component is contingent upon the execution of all other components.

⁴ See our client update, “Recent CFTC Actions Relating to Mandatory Exchange-trading of Swaps,” <http://www.debevoise.com/clientupdate20140227b>.

⁵ A U.S. Dollar Swap Spread is a package transaction in which all of the non-swap components are U.S. Treasury securities. A MAT/Non-MAT Cleared Package Transaction is a package transaction in which each of the swap components (including those that are not subject to the Trade Execution Requirement) are subject to the clearing requirement under section 2(h)(1)(A) of the CEA and CFTC regulation 50.4.

the broadest relief among those categories.

MAT/Agency MBS Package Transactions: These are package transactions in which each of the swap components is subject to the Trade Execution Requirement and all other components are agency mortgage-backed securities. The No-Action Letter provides that the DMO will not recommend that the CFTC take enforcement action against (1) any entity or counterparty that executes the swap components of such a package transaction without complying with the Trade Execution Requirement, or against (2) any SEF or DCM that facilitates trading in swap components of such package transactions without complying with the Method of Execution Requirements, if such swaps are executed before 11:59 p.m. (Eastern Time) on **May 15, 2015**. This is the only category of package transaction covered by the No-Action Letter for which the relief does not include relief from the Minimum Trading Functionality Requirements.

MAT/New Issuance Bond Package Transactions: These are package transactions which include at least one individual swap component that is subject to the Trade Execution Requirement and at least one individual component that is a bond issued and sold in the primary market.⁶ The No-Action Letter provides that the DMO will not recommend that the CFTC take enforcement action against (1) any entity or counterparty that executes the swap components of such a package transaction without complying with the Trade Execution Requirement, or against (2) any SEF or DCM that facilitates trading in swap components of such package transactions without complying with the Method of Execution or the Minimum Trading Functionality Requirements, if the swaps are executed before 11:59 p.m. (Eastern Time) on **February 12, 2016**.

MAT/Futures Package Transactions: These are package transactions which include at least one individual swap component that is subject to the Trade Execution Requirement and all other components that are contracts for the purchase or sale of a commodity for future delivery (i.e., futures contracts). The No-Action Letter provides that the DMO will not recommend that the CFTC take enforcement action against (1) any entity or counterparty that executes the swap components of such a package transaction without complying with the Trade Execution Requirement, or against (2) any SEF or DCM that facilitates trading in swap components of such package transactions without complying

⁶ This category specifically excludes package transactions with at least one component that is a bond transaction that occurs in the secondary market (but no component that is a bond transaction in the primary market). Such transactions would qualify as MAT/Non-Swap Instruments Package Transactions (discussed below).

with the Method of Execution or Minimum Trading Functionality Requirements, if such swaps are executed before 11:59 p.m. (Eastern Time) on **November 14, 2015**.

MAT/Non-MAT Uncleared Package Transactions: These are package transactions which include at least one individual swap component that is subject to the Trade Execution Requirement and at least one individual swap component that is subject to the CFTC's exclusive jurisdiction, but not subject to the clearing requirement under section 2(h)(1)(A) of the CEA and CFTC regulation 50.4. The No-Action Letter provides that the DMO will not recommend that the CFTC take enforcement action against (1) any entity or counterparty that executes the swap components of such a package transaction without complying with the Trade Execution Requirement, if such swaps are executed before 11:59 p.m. (Eastern Time) on **February 15, 2015**, or against (2) any SEF or DCM that facilitates trading in swap components of such package transactions without complying with the Method of Execution or Minimum Trading Functionality Requirements, if such swaps are executed before 11:59 p.m. (Eastern Time) on **February 12, 2016**.

MAT/Non-Swap Instruments Package Transactions: These are package transactions which include at least one individual swap component that is subject to the Trade Execution Requirement and at least one individual component that is not a swap. This category specifically excludes U.S. Dollar Swap Spreads, MAT/Futures Package Transactions, MAT/Agency MBS Package Transactions and MAT/New Issuance Bond Package Transactions. The No-Action Letter provides that the DMO will not recommend that the CFTC take enforcement action against (1) any entity or counterparty that executes the swap components of such a package transaction without complying with the Trade Execution Requirement, if such swaps are executed before 11:59 p.m. (Eastern Time) on **February 15, 2015**, or against (2) any SEF or DCM that facilitates trading in swap components of such package transactions without complying with the Method of Execution or Minimum Trading Functionality Requirements, if such swaps are executed before 11:59 p.m. (Eastern Time) on **February 12, 2016**.

MAT/Non-CFTC Swap Package Transactions: These are package transactions which include at least one individual swap component that is subject to the Trade Execution Requirement and at least one individual swap component that is a swap over which the CFTC does not have exclusive jurisdiction, such as

“mixed swaps.” The No-Action Letter provides that the DMO will not recommend that the CFTC take enforcement action against (1) any entity or counterparty that executes the swap components of such a package transaction without complying with the Trade Execution Requirement, if such swaps are executed before 11:59 p.m. (Eastern Time) on **February 15, 2015**, or against (2) any SEF or DCM that facilitates trading in swap components of such package transactions without complying with the Method of Execution or Minimum Trading Functionality Requirements, if such swaps are executed before 11:59 p.m. (Eastern Time) on **February 12, 2016**.

With respect to the last three categories of package transactions described above, for which the relief from the Trade Execution Requirement expires prior to the relief from the Method of Execution Requirement, the DMO clarifies that upon expiration of the relief from the Trade Execution Requirement (i.e., February 15, 2015), entities or counterparties will be required to execute the swap components of such package transactions that are subject to the Trade Execution Requirement on a SEF or DCM, but will be permitted to do so using any method of execution offered on a SEF or DCM (i.e., a trading system, facility or platform) until February 12, 2016.

With respect to all six categories of package transactions covered by the No-Action Letter, until the expiration of the relief from the Method of Execution Requirement, a SEF or DCM will be permitted to provide a trading system, facility or platform that facilitates trading of swap components of such package transactions through any method of execution, including through methods that do not comply with the Method of Execution Requirement. With respect to all such package transactions other than MAT/Agency MBS Package Transactions, until expiration of the relief from the Minimum Trading Functionality Requirement, a SEF or DCM is not required to offer an Order Book for any swap components of such transactions. The DMO notes that it expects SEFs and DCMs will implement and enforce rules that will allow them to verify that only eligible swap components are executed in reliance on such relief.

In the No-Action Letter, the DMO notes that the bond component of a MAT/New Issuance Bond Package Transaction, the agency MBS component of a MAT/Agency MBS Package Transaction, the non-swap components of a MAT/Non-Swap Instruments Package Transaction and the mixed swap component of a MAT/Non-CFTC Swap Package Transaction each may

⁷ A “mixed swap” is an example of a swap over which the CFTC may share jurisdiction with the Securities and Exchange Commission.

constitute a “security” (as defined in the Securities Act and the Securities Exchange Act) and, to the extent that SEFs and DCMs may be facilitating package transactions on their respective trading systems, facilities or platforms that involve a security, or any component agreement, contract or transaction over which the CFTC does not have exclusive jurisdiction, the DMO does not opine on whether such activity complies with other applicable law and regulations, and the No-Action Letter does not bind the CFTC or any other federal agency.

* * *

Please do not hesitate to contact us with any questions.