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Via Electronic Submission

Ms. Melissa Jurgens  
Secretary of the Commission  
Office of the Secretariat  
Commodity Futures Trading Commission  
Three Lafayette Center  
1155 21<sup>st</sup> Street, N.W.  
Washington, D.C. 20581

**Re: Request from CME Group to Amend Rule 538 (Exchange for Related Positions) and Issue CME Group Market Regulation Advisory Notice RA1311-5**

Dear Ms. Jurgens:

The Futures Industry Association (“**FIA**”) appreciates the opportunity to provide the Commodity Futures Trading Commission (“**CFTC**”) with the comments and recommendations set forth below in response to the CFTC’s September 17, 2013 request for comment concerning the CME Group’s request for approval to amend existing Rule 538 of the Chicago Mercantile Exchange Inc., the Board of Trade of the City of Chicago, Inc., New York Mercantile Exchange, Inc., Commodity Exchange, Inc., and the Board of Trade of Kansas City, Missouri, Inc. (collectively, the “**Exchanges**”) and issue CME Group Market Regulation Advisory Notice RA 1311-5.

**I. Summary of Proposed Amendments**

The Exchanges seek, among other things, CFTC approval to eliminate the use of “transitory” Exchange for Related Position transactions (“**EFRP**”). The Exchange rules propose to define “transitory” EFRPs as:

EFRPs in which the execution of an EFRP is contingent upon the execution of another EFRP or related position transaction between the parties and where the transactions result in the offset of the related positions without the incurrance of market risk that is material to the context of the related position transactions.

The proposed amendments to Rule 538.C state that “[e]ach EFRP requires a *bona fide* transfer of ownership of the underlying asset between the parties or a *bona fide*, legally binding contract between the parties consistent with relevant market conventions for the particular related position transaction.”

The Exchanges also seek to make a number of other material changes to Rule 538 and the “FAQ Related to Rule 538” that raise concerns for clearing members and market participants. These proposed changes include new provisions concerning when an EFP is deemed accepted by the Clearing House, new documentation changes related to reporting the actual delivery quantity associated with an EFP, and new internal control requirements for clearing members.

## **II. FIA’s Interest in the CME Group Request and Summary of FIA’s Comments**

FIA members are active users of the commodity futures markets, including EFRP transactions and block trades. In addition, FIA’s members provide clearing services related to EFRP transactions and block trades.

For the reasons explained below, FIA requests that the CFTC defer consideration of the CME’s proposal to amend CME Rule 538 until after the CFTC issues regulations implementing Designated Contract Market (“**DCM**”) Core Principle 9 and any proposed rules that would apply to block futures trades or EFRPs executed on DCMs. FIA believes that all rules related to the execution of transactions on DCMs are interrelated and should be designed to preserve the ability of market participants to access, and transact in, the commodity futures markets. If DCM trade execution rules are not carefully coordinated, market participants may not be able to access, or minimize execution risk in, less liquid futures contracts to manage the risks that they incur in their normal commercial operations and transactions. If that happens, market participants may be forced to seek alternative markets and venues in which to manage those risks. Moreover, if the combination of the CME Group’s proposed changes to Rule 538 and Commission regulations implementing Core Principle 9 and the execution of block trades reduces liquidity in the futures markets, it will adversely affect the business of FIA’s clearing member firms.

## **III. Comments on the CME Group’s Request**

### **A. The Use of Transitory EFRPs by Market Participants**

Market participants use transitory EFRPs for a number of *bona fide* business purposes, including to:

- Ensure that they can acquire positions in less liquid futures markets and do so without affecting the transaction execution price;
- Facilitate inventory finance transactions;<sup>1</sup>
- Enable them to initiate the execution of transactions in more liquid over-the-counter (“**OTC**”) spot, forward and swap markets to reduce execution risk; and
- Benefit from the reduced credit risk afforded by acquiring futures positions cleared by the exchange clearing house.

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<sup>1</sup> FIA supports CME Group’s proposed amendment to Rule 538.D.

The CFTC and exchanges have permitted and been aware of market practices related to EFRPs, including transitory EFRP transactions, for several decades. CFTC Rule 1.38 permits market participants to transact EFRPs outside of the competitive execution requirement provided that they comply with Commission-approved exchange rules. In accordance with CFTC Rule 1.38, the Exchanges' rules currently permit transitory EFRPs in energy, metals and foreign exchange ("FX") commodities.<sup>2</sup> The CFTC's Division of Trading and Markets ("DTM") October 1, 1987 Report On Exchange of Futures for Physicals commented on the use of transitory EFRPs by market participants.<sup>3</sup> In addition, through various exchange rule enforcement reviews, the Division of Market Oversight ("DMO") (formerly DTM) has been aware that market participants transact transitory EFRPs in permitted commodities.<sup>4</sup>

DCM Core Principle 9 of the Commodity Exchange Act ("CEA"), as amended by the Dodd-Frank Wall Street Reform and Accountability Act ("**Dodd-Frank Act**"), expressly permits EFRPs for *bona fide* business purposes.<sup>5</sup> Notably, the authority of DCMs to permit EFRP transactions in CEA section 5(d)(9)(B) is not conditioned on compliance with the competitive execution requirement of CEA section 5(d)(9)(B).

## **B. Block Trades and DCM Core Principle 9**

Like EFRPs, block futures transactions are not subject to the competitive trade execution requirement.<sup>6</sup> Market participants enter into block futures transactions for many of the same reasons as EFRPs – principally to increase the certainty of transaction execution at a single price. Depending upon transaction size and market liquidity, market participants may have the ability to execute either EFRPs or block trades to achieve their business purposes.

The CFTC is considering, but has yet to finalize, rules related to the trade execution requirement in DCM Core Principle 9. In addition, FIA understands that the CFTC is considering additional rules related to block trades. To provide the Commission with meaningful and comprehensive comments on the CME Group's proposal to eliminate transitory EFRPs, FIA and its members need to consider the proposal in connection with the CFTC's yet-to-be-issued final rules implementing trade execution requirements in DCM Core Principle 9 and any

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<sup>2</sup> See e.g. *NYMEX Notice to Members*, Notice No. 04-172 (May 4, 2004) ("If customers A and B did NOT have some form of long-dated OTC contract which they were effectively novating to NYMEX via the CPC transaction then, they will have to create some form of transitory obligation between the parties."); *CME and CBOT Market Regulation Advisory Notice*, RA0809-3 (May 1, 2008) ("Transitory EFRPs are permitted in CME Currency futures and in CBOT 100 oz. Gold futures and CBOT 5,000 oz. Silver futures"); and CME, CBOT, NYMEX and COMEX Market Regulation Advisory Notice CME Group RA1006-5 (June 11, 2010) (Transitory EFRPs...are permitted exclusively in NYMEX energy and metals products, COMEX metals products, and CME FX products.").

<sup>3</sup> See *Report on Exchange of Futures for Physicals*, CFTC Division of Trading and Markets (Oct. 1, 1987).

<sup>4</sup> See e.g. *CFTC Division of Market Oversight Market Surveillance Rule Enforcement Review of the New York Mercantile Exchange* (May 19, 2008).

<sup>5</sup> See CEA section 5(d)(9)(B)(ii).

<sup>6</sup> See CME Rule 526.

regulations that the CFTC may propose concerning block trades. In certain instances, the minimum size requirements for block trades exceed the size of some transactions that many market participants seek to execute bilaterally and then settle via an EFRP. The interplay between the CME Group's proposed changes to Rule 538 and the Commission's yet to be issued rules concerning Core Principle 9 and block trades could affect the ability of market participants to execute transactions for *bona fide* business purposes.

**C. Potential Consequences of Approving the CME Group's Request Without Considering the Impact of Other Commission Trade Execution Rules**

If CFTC-approved DCM trade execution rules related to block trades and the CME Group's proposed changes to its EFRPs are not carefully coordinated, market participants may not be able to access, or minimize execution risk in, less liquid futures contracts. For example, if the CFTC approves the CME Group's request to eliminate transitory EFRPs and the CFTC later issues rules that have the effect of requiring exchanges to increase the minimum size of block trades, FIA believes that such a combination of regulatory restrictions could have several unintended and adverse effects on sound regulatory policy, DCMs, futures commission merchants ("FCMs") and market participants for the following, among other, reasons:

- There likely would be insufficient liquidity for market participants to execute transactions below the minimum block size via a DCM's central limit order book. If so, market participants may not be able to manage risk in an efficient manner because they may need to: (1) execute transactions in alternative markets in other jurisdictions that offer comparable or related products; or (2) execute transactions as swaps that likely would not be subject to mandatory clearing or mandatory trade execution requirements;
- The OTC FX market, in particular, is a robust, twenty-four hour market with consistent buy- and sell-side liquidity provided by market participants located in many regions. Market participants in the FX market rely upon EFRPs for efficient execution, in part, because the minimum block trade threshold for FX contracts is higher than for most other physically-settled futures contracts. Eliminating transitory EFRPs may result in a substantial decrease in liquidity in the FX markets and increase transaction costs for market participants seeking to manage risk in a cost-effective manner. The same adverse effects can be expected to occur in all commodity markets if minimum futures contract block sizes increase above current levels.
- If market participants have to locate alternative markets with comparable products to execute transactions below the minimum block size, it could fracture liquidity in the futures markets. For example, liquid contracts, such as natural gas futures, could continue to be traded in the futures market, but other related but less liquid contracts, such as natural gas basis contracts, would have to be traded OTC or on a SEF;

- If the relevant swaps are cleared, FCMs and market participants would not be able to cross-margin cleared swaps positions with cleared futures positions;
- If the swaps eventually become standardized, executed on a SEF and cleared, the absence of a SEF corollary to DCM Core Principle 9 means that DCM Core Principle 9 will effectively have forced the transactions to move from futures to swaps, but there would be no statutory or regulatory requirement to move swaps from SEFs back to DCMs as the liquidity of trading in those swaps increased.

#### **D. Proposed Rule 538.I – Submission to the Clearing House**

The Exchanges' proposed Rule 538.I amends former CME Rule 538.G to assert that:

An EFRP transaction submitted to the Clearing House *shall not be considered accepted by the Clearing House* until the transaction has cleared and the first payment of settlement variation and performance bond has been confirmed. (Emphasis added.).

This proposed amendment to the rule text, if approved by the CFTC, would create considerable uncertainty for a period that could extend up to 24 hours regarding whether the parties to an EFRP had entered into a binding and enforceable transaction.<sup>7</sup>

There is no sound regulatory or policy reason for a delay by the Clearing House in accepting the EFRP for clearing. FIA understands that, currently, when a registered/approved trader or broker enters an EFRP or block trade in Clearport, the trader receives an email from the Clearing House that enables the trader to access Clearport to review the trade details, including the status of the transaction, which invariably shows it as "Cleared." If a broker attempts to enter an EFRP or block trade into Clearport that fails a system control (*e.g.*, the firm or trader is not registered or risk limits are not set or are violated), the trade will be rejected and it will not be accepted by Clearport. However, if all system controls clear, the trade will promptly enter Clearport and the status will promptly show the trade as "Cleared."

To FIA's knowledge, there is no delay in the cleared status of the EFRP until after the settlement variation and performance bond have been confirmed. Moreover, the Clearing House accepts block futures trades for clearing as soon as they are reported. There is no reason why the Clearing House should differentiate between when it accepts block futures trades and EFRP transactions for clearing. In both cases, the clearing member guarantees performance of the transaction to the Clearing House.<sup>8</sup> There also is no sound regulatory or policy reason for differentiating between the requirement that a Clearing House accept swaps for clearing as soon

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<sup>7</sup> CME Group previously stated this position in the FAQ Related to Rule 538 as part of Market Regulation Advisory Notice CME Group RA1006-5 (June 11, 2010) (FAQ 16).

<sup>8</sup> See CME Rule 901.I.

as “technologically practicable” and the time when a Clearing House must accept an EFRP for clearing.<sup>9</sup>

#### **E. FCM Obligations Under CME Group FAQ 26**

CME Group FAQ 26 related to Exchange Rule 538 indicates that FCMs have three responsibilities with respect to EFRPs that FCMs execute or clear: (1) to make sure their customers are fully informed about exchange EFRP requirements; (2) to obtain and submit records of their customers’ EFRP transactions in a timely and complete manner; and (3) to establish, document and execute controls reasonably designed to prevent and detect the execution of non-*bona fide* EFRPs.

FIA recommends that the CFTC require CME Group to make the following modifications to the answers to FAQ 26:

- Because persons who trade on DCMs are required to be aware of, and comply with, exchange rules, FCMs should not be required to make sure that their customers are fully informed about exchange EFRP requirements;
- FCMs should only be required to “request” records of customer EFRP transactions, and submit such documents in a timely manner once provided by the customer; and
- The CFTC should require that CME delete the requirement for FCMs to document and execute controls reasonably designed to prevent and detect the execution of non-*bona fide* EFRPs.

Current Rule 538.G. requires FCMs to exercise “reasonable diligence” about the *bona fide* nature of EFRPs that they submit on behalf of their customers. In addition, current FAQ 24 states that “a firm that accepts and clears an EFRP that is given-up may be liable for violation of Rule 538 if it accepts an EFRP that it *knows, or should know*, is not *bona fide*.” (Emphasis added). FCMs have been able to operate for many years within these standards. CME provided no explanation as to why its new proposed clearing member EFRP controls are necessary.

In addition, the CME Group’s proposal is commercially impractical and fails to take into account the information available to a clearing member when clearing an EFRP. An FCM that is not a party to an EFRP with a customer only learns about the EFRP after it has been agreed to by the principals. A clearing member has no practical way to detect or prevent in advance the execution of a transaction that has already occurred. That is why the CME should retain the “knows or should know” standard for clearing member responsibility not to accept non-*bona fide* EFRPs.

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<sup>9</sup> See CFTC Rules 1.74 and 23.610.

**F. CME Group FAQ 22**

The CME Group FAQ 22 purports to require market participants to agree in a contract if they want to submit a transaction to the Clearing House within the required reporting period following the time when the actual delivery quantities are determined, rather than reporting the EFRP when the price is agreed. Deliveries of all physical commodities require, by nature and course of dealing, flexibility within operational tolerances to account for the practical aspects of transporting and storing physical commodities. The transaction should be reported when all of the material terms, including the quantity, have been agreed by the parties. FIA is unaware of any policy reason to require market participants to create or amend their transaction documentation in order to continue existing commercially reasonable practices for reporting EFRPs.

**G. Transition Period**

If the Commission approves CME Group's request, the elimination of transitory EFRPs should only be effective after a transition period to enable market participants to minimize the costs that they incur as a result of the changes, and to find alternative means or venues to execute transactions. The transition period should overlap with the introduction of new block trade rules to ensure that market participants can continue to access the futures markets in an efficient manner rather than having to seek alternatives outside of the futures markets

FIA appreciates the opportunity to provide additional information to Staff as it considers recommendations for a new rule setting aggregation and *bona fide* hedging transactions. Please contact Barbara Wierzynski, General Counsel of the FIA at 202-466-5460, if you have any questions about FIA's comments or recommendations.

Sincerely,



Walt Lukken  
President & Chief Executive Officer

cc: Honorable Gary Gensler, Chairman  
Honorable Scott O'Malia  
Honorable Mark Wetjen  
Honorable Bart Chilton  
Jonathan Marcus, General Counsel  
Vincent McGonagle, Director, DMO  
Ananda Radhakrishnan, Director, DCR  
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