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A Legal Update from Dechert's Financial Services Group

## CFTC Issues Guidance on Block Trade and Large Notional Off-Facility Swap Rules; Advisers Must Obtain Consents

The U.S. Commodity Futures Trading Commission (“CFTC”) has issued final rules (“Final Rules”) setting minimum block trade sizes for different types of CFTC-regulated swaps that are permitted to be executed off-facility and with a time delay in public reporting. These rules are an exception to CFTC regulations requiring real-time reporting of swap transaction and pricing data. This *DechertOnPoint* describes how investment advisers (“Advisers”)<sup>1</sup> may engage in these types of excepted trades, including when client consent is necessary, when aggregating orders across multiple clients to reach the minimum block trade sizes is permitted and the steps Advisers may need to take to obtain client consent to aggregate orders.

### Background

The Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) directs the CFTC to promulgate regulations that require the real-time reporting of swap transaction and pricing data.<sup>2</sup> However, Dodd-Frank also provides an exception to the real-time reporting requirement by requiring the CFTC to establish “the criteria for determining what constitutes a large notional swap transaction (block trade) for particular markets and contracts” and “the appropriate time delay for reporting [such large trades] to the public.”<sup>3</sup> In making this determination, the CFTC must consider whether real-time disclosure “will materially reduce market liquidity.”<sup>4</sup> In addressing market liquidity, the CFTC acknowledged that real-time reporting of large trades could reduce market liquidity by alerting swap dealers and other market participants that a counterparty to a large trade would likely also need to enter into a large offsetting trade, giving swap dealers and other market participants the ability to charge a premium for such an offsetting trade.<sup>5</sup>

Accordingly, the Final Rules set minimum block trade sizes for different types of swaps<sup>6</sup> that may be executed off-facility and with a reporting delay.<sup>7</sup> If a swap is traded in a notional amount above a specified

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<sup>1</sup> For the purposes of this *OnPoint*, the term “Advisers” is not limited to registered investment advisers.

<sup>2</sup> Section 727 of Dodd-Frank; codified as Section 2(a)(13) of the Commodity Exchange Act, as amended (“CEA”).

<sup>3</sup> CEA Section 2(a)(13)(E).

<sup>4</sup> CEA Section 2(a)(13)(E)(iv).

<sup>5</sup> Procedures To Establish Appropriate Minimum Block Sizes for Large Notional Off-Facility Swaps and Block Trades, 78 Fed. Reg. 32866, 32870 (May 31, 2013) (“Adopting Release”).

<sup>6</sup> Note that swaps on equities are not subject to the Final Rules.

minimum size, the swap may be reported to the public on a delayed basis and need not be traded on a swap execution facility (“SEF”) or designated contract market (“DCM”).<sup>8</sup>

While the block trade rules were technically effective July 30, 2013, the rules are not applicable until clearing is required and it is possible to trade swaps on a SEF or DCM. Accordingly, compliance will be required by the later of (i) the applicable deadline for mandatory clearing for the relevant swap, or (ii) 30 days following a determination from the CFTC that the swap is “available-to-trade” on a SEF and/or DCM.<sup>9</sup> The CFTC has not yet given final approval to the registration of any SEFs; however, on July 30, 2013, the CFTC issued an order for temporary registration of Bloomberg SEF LLC, the first SEF to receive such an order.<sup>10</sup> It is unclear when the CFTC may determine that any swap is “available-to-trade” on a SEF and/or DCM.

## Block Trades vs. Large Notional Off-Facility Swaps

The Final Rules apply to “block trades” as well as “large notional off-facility swaps.” In general, a block trade is a large swap transaction listed for trading on a SEF and/or DCM (also referred to as a “facility”) and executed according to the rules of the facility (but due to its size does not need to be actually executed on the facility); and a “large notional off-facility swap” is a large, OTC swap transaction that is not executed according to the rules of a facility.

Specifically, CFTC regulations define a block trade as a publicly-reportable swap transaction that: (i) involves a swap that is listed on a SEF or DCM; (ii) occurs away from the SEF’s or DCM’s trading system but is executed pursuant to the SEF’s or DCM’s rules and procedures;<sup>11</sup> (iii) has a notional amount at or above the specified minimum notional order size applicable to the swap; and (iv) is reported subject to the rules and procedures of the SEF or DCM and the CFTC’s real-time reporting rules.<sup>12</sup> In contrast, CFTC regulations define a large notional off-facility swap as a publicly-reportable swap transaction that: (i) is not executed on or pursuant to the rules of a SEF or DCM; (ii) has a notional amount above the specified minimum notional order size applicable to the swap; and (iii) is not a block trade.<sup>13</sup>

The key practical effects of whether a swap trade is a block trade or a large notional off-facility swap are (i) whether client consent is required to take advantage of the reporting delay and (ii) whether an Adviser may

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<sup>7</sup> The CFTC has published a chart listing these minimum swap sizes which is included at the end of this *OnPoint*. 78 Fed. Reg. 42436 (Jul. 16, 2013). This chart corrects the chart that the CFTC originally published in the Adopting Release.

<sup>8</sup> A DCM is an exchange for both futures and swaps.

<sup>9</sup> See CFTC Reg. 37.12.

<sup>10</sup> CFTC Notice of Grant of Temporary Registration of Bloomberg SEF LLC as a Swap Execution Facility Pursuant to Part 37 of the Commission’s Regulations (Jul. 30, 2013).

<sup>11</sup> If a trade is placed on a SEF or DCM, information about the swap trade would be publicly-available without delay.

<sup>12</sup> CFTC Reg. 43.2.

<sup>13</sup> *Id.*

aggregate the orders of various clients to meet the minimum order sizes and qualify as a block trade or large notional off-facility swap.

## Client Consent

Whether an Adviser needs written consent from its clients to avail itself of the reporting delay depends on whether the particular trade is a block trade or a large notional off-facility swap. If the transaction is a large notional off-facility swap, no client consent is required. However, if the transaction is a block trade, the Adviser will need to have an express consent from its clients in the applicable investment management agreements.<sup>14</sup> A general grant of investment management discretion is not adequate.<sup>15</sup>

## Aggregating Orders Across Multiple Clients

An Adviser may also want the ability to aggregate the orders of multiple clients to reach the specified minimum notional size for block trades and large notional off-facility swaps. An Adviser may aggregate client orders with respect to block trades, provided that certain requirements are met (described below).<sup>16</sup> In addition, on July 30, 2013, the CFTC Division of Market Oversight (“Division”) granted no-action relief permitting the aggregation of orders for large notional off-facility swaps until October 1, 2013, provided that the same requirements that apply to aggregating block trades are met.<sup>17</sup> Once this no-action relief expires, aggregation across clients to reach the specified minimum order size will be prohibited for large notional off-facility swaps.<sup>18</sup> The relief also treats all trades above the specified minimum order sizes as large notional off-facility swaps, presumably until swaps are determined available-to-trade and thus subject to applicable SEF or DCM rules. Essentially, until swaps are listed for trading on DCMs or SEFs, large trades above the block trade size minimums are all large notional off-facility swaps, and aggregation is permitted with regard to those large notional off-facility swaps. A subsequent amendment to the no-action letter acknowledged that there are a few DCMs that currently offer a limited number of swaps for exchange trading. However, the Division plans to keep its no-action relief in place through October 1, 2013.<sup>19</sup>

An Adviser may aggregate orders for block trades if the following requirements are met: (i) aggregation is permitted on the relevant SEF or DCM;<sup>20</sup> (ii) the Adviser has more than \$25 million in assets under

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<sup>14</sup> CFTC Reg. 43.6(i)(2).

<sup>15</sup> Adopting Release at 32906.

<sup>16</sup> See CFTC Reg. 43.6(h)(6).

<sup>17</sup> No-Action Relief For Certain Commodity Trading Advisors and Investment Advisors From the Prohibition of Aggregation Under Regulation 43.6(h)(6) for Large Notional Off-Facility Swaps, CFTC Letter No. 13-48 (Jul. 30, 2013).

<sup>18</sup> See CFTC Reg. 43.6(h)(6).

<sup>19</sup> No-Action Relief For Certain Commodity Trading Advisors and Investment Advisors From the Prohibition of Aggregation Under Regulation 43.6(h)(6) for Large Notional Off-Facility Swaps, CFTC Letter No. 13-48 Amended (Aug. 6, 2013).

<sup>20</sup> CFTC Reg. 43.6(h)(6).

management;<sup>21</sup> and (iii) the Adviser is one of the following— (A) a registered or exempt commodity trading advisor (“CTA”) which has discretionary trading authority or directs client accounts,<sup>22</sup> (B) a registered investment adviser (“RIA”) which has discretionary trading authority<sup>23</sup> or (C) a foreign equivalent to a CTA or RIA.<sup>24</sup> In addition, the aggregated orders must be executed as a single swap order and may not be aggregated after they have been executed.<sup>25</sup> Furthermore, while the Final Rules do not expressly require client consent for aggregating positions with other clients in order to reach the minimum block trade size, the Adopting Release suggests that such consent must be obtained.<sup>26</sup>

## Action Steps for Advisers

For new clients, Advisers should include in their form investment management agreements an express consent from the clients permitting block trading and aggregation for block trading. According to the Adopting Release, consent is necessary because a client may not receive the best terms for an individual swap transaction that is part of a block trade and thus should be able to decide whether to allow such transactions.<sup>27</sup> For existing accounts, Advisers should determine whether they will transact in block trades for one or more accounts; and if so, the Adviser should likewise obtain an express consent from its clients permitting block trading and aggregation for block trading. Advisers seeking client consent should also disclose to clients the relevant risks involved in such trading and activity.



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<sup>21</sup> CFTC Reg. 43.6(h)(6)(ii).

<sup>22</sup> CFTC Reg. 43.6(h)(6)(i)(A).

<sup>23</sup> CFTC Reg. 43.6(h)(6)(i)(B).

<sup>24</sup> CFTC Reg. 43.6(h)(6)(i)(C).

<sup>25</sup> CFTC Letter No. 13-48 (Aug. 6, 2013) at 3.

<sup>26</sup> Adopting Release at 32906.

<sup>27</sup> *Id.*

## APPENDIX

### CFTC INITIAL BLOCK SIZES BY ASSET CLASS

Currency group	Currencies
Super-Major Currencies	United States dollar (USD), European Union Euro Area euro (EUR), United Kingdom pound sterling (GBP), and Japan yen (JPY).
Major Currencies	Australia dollar (AUD), Switzerland franc (CHF), Canada dollar (CAD), Republic of South Africa rand (ZAR), Republic of Korea won (KRW), Kingdom of Sweden krona (SEK), New Zealand dollar (NZD), Kingdom of Norway krone (NOK), and Denmark krone (DKK).
Non-Major Currencies	All other currencies.

### INTEREST RATE SWAPS

Currency group	Tenor greater than	Tenor less than or equal to	Minimum Notional (in millions)
Super-Major		46 days	6,400
Super-Major	46 days	Three months (107 days)	2,100
Super-Major	Three months (107 days)	Six months (198 days)	1,200
Super-Major	Six months (198 days)	One year (381 days)	1,100
Super-Major	One year (381 days)	Two years (746 days)	460
Super-Major	Two years (746 days)	Five years (1,842 days)	240
Super-Major	Five years (1,842 days)	Ten years (3,668 days)	170
Super-Major	Ten years (3,668 days)	30 years (10,973 days)	120
Super-Major	30 years (10,973 days)		67
Major		46 days	2,200
Major	46 days	Three months (107 days)	580
Major	Three months (107 days)	Six months (198 days)	440
Major	Six months (198 days)	One year (381 days)	220
Major	One year (381 days)	Two years (746 days)	130
Major	Two years (746 days)	Five years (1,842 days)	88
Major	Five years (1,842 days)	Ten years (3,668 days)	49
Major	Ten years (3,668 days)	30 years (10,973 days)	37
Major	30 years (10,973 days)		15
Non-Major		46 days	230
Non-Major	46 days	Three months (107 days)	230
Non-Major	Three months (107 days)	Six months (198 days)	150
Non-Major	Six months (198 days)	One year (381 days)	110
Non-Major	One year (381 days)	Two years (746 days)	54
Non-Major	Two years (746 days)	Five years (1,842 days)	27
Non-Major	Five years (1,842 days)	Ten years (3,668 days)	15
Non-Major	Ten years (3,668 days)	30 years (10,973 days)	16
Non-Major	30 years (10,973 days)		15

## CREDIT SWAPS

Spread group (basis points)	Traded tenor greater than	Traded tenor less than or equal to	Minimum Notional (in millions)
Less than or equal to 175		Two years (746 days)	320
Less than or equal to 175	Two years (746 days)	Four years (1,477 days)	200
Less than or equal to 175	Four years (1,477 days)	Six years (2,207 days)	110
Less than or equal to 175	Six years (2,207 days)	Eight years and six months (3,120 days).	110
Less than or equal to 175	Eight years and six months (3,120 days).	Twelve years and six months (4,581 days).	130
Less than or equal to 175	Twelve years and six months (4,581 days).		46
Greater than 175 and less than or equal to 350.		Two years (746 days)	140
Greater than 175 and less than or equal to 350.	Two years (746 days)	Four years (1,477 days)	82
Greater than 175 and less than or equal to 350.	Four years (1,477 days)	Six years (2,207 days)	32
Greater than 175 and less than or equal to 350.	Six years (2,207 days)	Eight years and six months (3,120 days).	20
Greater than 175 and less than or equal to 350.	Eight years and six months (3,120 days).	Twelve years and six months (4,581 days).	26
Greater than 175 and less than or equal to 350.	Twelve years and six months (4,581 days).		63
Greater than 350		Two years (746 days)	66
Greater than 350	Two years (746 days)	Four years (1,477 days)	41
Greater than 350	Four years (1,477 days)	Six years (2,207 days)	26
Greater than 350	Six years (2,207 days)	Eight years and six months (3,120 days).	13
Greater than 350	Eight years and six months (3,120 days).	Twelve years and six months (4,581 days).	13
Greater than 350	Twelve years and six months (4,581 days).		41

## FOREIGN EXCHANGE SWAPS

		Super-major currencies			
		EUR (Euro)	GBP (British pound)	JPY (Japanese yen)	USD (US dollar)
Super-major currencies	EUR		6,250,000	6,250,000	18,750,000
	GBP		* 6,250,00	6,250,000	6,250,000
	JPY	* 6,250,000		* 6,250,000	1,875,000,000
	USD	* 18,750,000	* 6,250,000		* 1,875,000,000
Major currencies	AUD	* 6,250,000	0	10,000,000	10,000,000
	CAD	* 6,250,000	0	10,000,000	10,000,000
	CHF	* 6,250,000	* 6,250,000	12,500,000	12,500,000
	DKK	0	0	0	0
	KRW	0	0	0	6,250,000,000
	SEK	* 6,250,000	0	0	100,000,000
	NOK	* 6,250,000	0	0	100,000,000
	NZD	0	0	0	5,000,000
Non-major currencies	ZAR	0	0	0	25,000,000
	BRL	0	0	0	5,000,000
	CZK	200,000,000	0	0	200,000,000
	HUF	1,500,000,000	0	0	1,500,000,000
	ILS	0	0	0	50,000,000
	MXN	0	0	0	50,000,000
	PLN	25,000,000	0	0	25,000,000
	RMB	50,000,000	0	50,000,000	50,000,000
	RUB	0	0	0	125,000,000
	TRY	*6,250,000	0	0	* 10,000,000

All values that do not have an asterisk are denominated in the currency of the left hand side. All values that have an asterisk (\*) are denominated in the currency indicated on the top of the table.

## OTHER COMMODITY SWAPS

Related futures contract	Initial appropriate minimum block size
AB NIT Basis (ICE)	62,500
Brent Crude (ICE and NYMEX)	25,000
Cheese (CME)	400,000
Class III Milk (CME)	NO BLOCKS.
Cocoa (ICE and NYSE LIFFE and NYMEX)	1,000
Coffee (ICE and NYMEX)	3,750,000
Copper (COMEX)	625,000
Corn (CBOT)	NO BLOCKS
Cotton No. 2 (ICE and NYMEX)	5,000,000
Distillers' Dried Grain (CBOT)	1,000
Dow Jones-UBS Commodity Index (CBOT)	30,000 times index
Ethanol (CBOT)	290,000
Feeder Cattle (CME)	NO BLOCKS
Frost Index (CME)	200,000 times index
Frozen Concentrated Orange Juice (ICE)	NO BLOCKS
Gold (COMEX and NYSE Liffe)	2,5000
Goldman Sachs Commodity Index (GSCI), GSCI Excess Return Index (CME)	5,000 times index
Gulf Coast Sour Crude Oil (NYMEX)	5,000
Hard Red Spring Wheat (MGEX)	NO BLOCKS
Hard Winter Wheat (KCBT)	NO BLOCKS
Henry Hub Natural Gas (NYMEX)	500,000
HSC Basis (ICE and NYMEX)	62,500
Hurricane Index (CME)	20,000 times index
Chicago Basis (ICE and NYMEX)	62,500
Lean Hogs (CME)	NO BLOCKS
Light Sweet Crude Oil (NYMEX)	50,000
Live Cattle (CME)	NO BLOCKS
Mid-Columbia Day-Ahead Off-Peak Fixed Price (ICE)	625
Mid-Columbia Day-Ahead Peak Fixed Price (ICE)	4,000
New York Harbor RBOB (Blendstock) Gasoline (NYMEX)	1,050,000
New York Harbor No. 2 Heating Oil (NYMEX)	1,050,000
NWP Rockies Basis (ICE and NYMEX)	62,500
Oats (CBOT)	NO BLOCKS
Palladium (NYMEX)	1,000
PG&E Citygate Basis (ICE and NYMEX)	62,500
PJM Western Hub Real Time Off-Peak Fixed Price (ICE)	3,900
PJM Western Hub Real Time Peak Fixed Price (ICE)	8,000
Platinum (NYMEX)	500
Rainfall Index (CME)	10,000 times index
Rough Rice (CBOT)	NO BLOCKS
Silver (COMEX and NYSE Liffe)	125,000
Snowfall Index (CME)	10,000 times index
Socal Border Basis (ICE and NYMEX)	62,500
Soybean (CBOT)	NO BLOCKS
Soybean Meal (CBOT)	NO BLOCKS
Soybean Oil (CBOT)	NO BLOCKS
SP-15 Day-Ahead Peak Fixed Price (ICE)	4,000
SP-15 Day-Ahead Off-Peak Fixed Price (ICE)	625
Sugar #11 (ICE and NYMEX)	5,000
Sugar #16 (ICE)	NO BLOCKS
Temperature Index (CME)	400 times index
US Dollar Cash Settled Crude Palm Oil (CME)	250
Waha Basis (ICE and NYMEX)	62,500
Wheat (CBOT)	NO BLOCKS

Source: Procedures to Establish Appropriate Minimum Block Sizes for Large Notional Off-Facility Swaps and Block Trades; Correction, 78 Fed. Reg. 42436 (Jul. 16, 2013).



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