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CFTC Proposes Minimum Block Trade Sizes and Swap Counterparty Identity Protections

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On February 23, 2012, by a 3-2 vote, the Commodity Futures Trading Commission (CFTC) proposed rules (the Proposal) to set the block trading levels for swaps and to prevent identity disclosure of swap counterparties. On December 20, 2011, the CFTC adopted rules to implement for swaps the real-time public reporting provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).[1] *See also* "The CFTC's New Swap Reporting and Recordkeeping Requirements," Skadden Client Alert (Jan. 17, 2012). At that time, the CFTC reserved the issue of defining those swaps "block trades"[2] that would be excused from the real-time reporting mandate.

The CFTC now has proposed to define the minimum thresholds that will determine which swaps are large enough to be exempt from the general real-time public reporting requirement as block trades. The public reporting of data on a swap that is designated as a block will be delayed for at least 30 minutes (and in some cases significantly longer) in an effort to allow liquidity-providing dealers and others to lay off their risk, a policy goal the Dodd-Frank Act expressly supports.

The CFTC also recognizes that, in some instances, when swap data is publicly reported, market participants may be able to discern the identities of the parties to the swap due to unique characteristics of the transaction. In the Dodd-Frank Act, Congress prohibited the disclosure of the identities of swap counterparties as part of the public reporting system. To that end, the CFTC proposes enhanced confidentiality protections for the identities of counterparties to swaps. Comments on the Proposal must be received by May 14, 2012.

I. Block Trade Size Thresholds

A primary goal of the Dodd-Frank Act's reform of swap regulation is to increase swap market transparency by, among other things, requiring reporting of all swap transaction data to swap data repositories (SDRs) and requiring real-time public reporting of information about the timing, price and volume of most swaps. The Dodd-Frank Act's public reporting provisions direct the CFTC to determine what constitutes a block trade for particular swap markets and contracts and to adopt appropriate time delays for publicly reporting block trades. The Proposal would set block trade size thresholds so market participants will know whether their swap is large enough to qualify as a block trade.

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1 Procedures to Establish Appropriate Minimum Block Sizes for Large Notional Off-Facility Swaps and Block Trades, 77 Fed. Reg. 15460 (Mar. 15, 2012).

2 For convenience, we use "block trade" to refer to two types of large swap transactions: block trades and large notional off-facility swaps. The CFTC has defined the term "block trade" to refer to a swap transaction that equals or exceeds the block trade size threshold and is executed pursuant to the rules of a swap execution facility (SEF) or designated contract market (DCM). In contrast, a "large notional off-facility swap" refers to a swap transaction that equals or exceeds the block trade size threshold and is not executed pursuant to SEF or DCM rules.

Will block size thresholds vary for different types of swaps?

Yes. In the real-time reporting rules, the CFTC established five asset classes for swaps — interest rate, credit, foreign exchange (FX), equity and other commodity. To account for differences in liquidity profiles between swaps in each asset class, the CFTC proposes to further divide each swap asset class into swap categories and to set block trade size thresholds on a category-by-category basis. The following chart illustrates the granularity of these categories:

Swap Asset Class	Number of Categories	Differentiating Factors
Interest Rate	24	Tenor, Currency
Credit	18	Tenor, Conventional spread[3]
FX	At least 400	Unique currency combinations (*e.g.*, U.S. dollar/ euro; U.S. dollar/ Canadian dollar)
Equity	1	N/A
Other commodity	At least 65	Whether the swap is economically related[4] to enumerated futures or swaps contracts, Whether the swap is economically related to a futures contract subject to a DCM's block trade rules, The underlying reference commodity of the swap

How would block sizes be determined?

The CFTC proposes a two-period, phased-in approach to establish block trade size thresholds. During the first phase, the CFTC would prescribe interim block trade size thresholds. This phase would begin 60 days after the Proposal is finalized and published in the Federal Register and would continue until i) SDRs have collected, and the CFTC has analyzed, at least one year's worth of swap transaction data and ii) updated thresholds that will be adopted by the CFTC based on this data take effect.[5] The second phase would begin on the first day of the second month after the CFTC publishes updated block trade size thresholds on its website. The CFTC would adjust block sizes at least annually, based on the data collected by the SDRs.

The CFTC proposes to use different criteria (described below) for determining interim and updated block trade size thresholds.[6] The CFTC provides the interim block trade size thresholds based on these criteria in Appendix F of the Proposal.

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3 The conventional spread of a swap represents the equivalent of a swap dealer's quoted spread for that swap.

4 Two contracts would be economically related if they have a direct or indirect reference to the same commodity at the same delivery location or locations, or with the same or a substantially similar cash market price series.

5 The data would be collected pursuant to Part 45 of the CFTC's regulations, which was adopted in December but has not yet taken effect.

6 The Proposal also contains procedures to address block trade size calculations for certain special situations, including: i) swaps with optionality; ii) swaps with composite reference prices; and iii) physical commodity swaps.

Methodology for calculating interim block trade size thresholds

The CFTC would establish interim block trade size thresholds according to the following methodologies:

- Interest rate and credit swaps — The block trade size threshold would be determined for each swap category by what the CFTC calls its "67% notional amount calculation" set forth in the Proposal. According to the CFTC, based on the data available to it, 6 percent of interest rate and credit swaps would be eligible to be block trades under the proposal.
- Foreign exchange swaps — If the swap is economically related to a futures contract, the minimum block trade size threshold would be based on the block trade size threshold set by DCMs for economically related futures contracts.[7] All foreign exchange swaps that are not economically related to a futures contract would qualify as a block trade, regardless of size.
- Equity swaps — No equity swaps would qualify as block trades.
- Other commodity swaps — Minimum block trade size thresholds will be determined as follows:
  - If a swap is economically related to a specified futures contract that is subject to a DCM's block trade rules, the block trade size threshold would be based on the block trade size threshold of the economically related futures contract. There would be no block trades if the economically related futures contract is not subject to a DCM's block trade rules.
  - If a swap is economically related to a specified natural gas or electricity swap, the block trade size threshold would be $25 million. This is the same threshold that would be used to determine whether the notional amount of the swap would be masked in public reports (discussed in more detail below).[8]
  - All other swaps in this asset class would be treated as block trades because the CFTC believes these swaps are less liquid than other types of swaps.

Methodology for calculating updated block trade size thresholds

During the second phase, the CFTC proposes that the block trade size thresholds for all swap categories (except for equity swaps) would be calculated using the 67-percent formula. This is the same formula that would be used to establish the interim block trade size thresholds for interest rate and credit swaps. However, the calculation of updated block trade size thresholds would be based on one to three years' worth of data collected by SDRs.

The Proposal notes that the CFTC is actively considering using a 50-percent calculation to calculate updated block trade size thresholds instead of the proposed 67-percent calculation. Under a 50-percent calculation, approximately 14-15 percent of the swaps in the CFTC's data set would be large enough to be block trades. The CFTC requests comment on which threshold is more appropriate.

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7 The CFTC suggests but does not explicitly state that the block trade size threshold for this category of swap would be equivalent to the block trade size for the economically related futures contract.

8 *See* 77 Fed Reg. 15519 for a list of enumerated contracts. These will be included in Appendix B to Part 43 of the CFTC's regulations.

Are swaps that meet or exceed the applicable block trade size threshold automatically treated as block trades?

No. A swap only would be considered a block trade if the counterparties designate it as such and notify the SEF, DCM or SDR, as appropriate, of their election. If the block trade is executed pursuant to the rules of a SEF or DCM, the parties would notify the appropriate SEF or DCM. For all other block trades, the parties would notify the SDR to which the swap is reported.

II. Protecting the Party's Identities When Swaps Are Publicly Reported.

Sections 2(a)(13)(C)(iii) and 2(a)(13)(E)(i) of the Commodity Exchange Act direct the CFTC to protect the identity of swap counterparties when swap transaction and pricing data are reported publicly. The CFTC proposes to implement these mandates by masking the notional amount of large swaps and limiting the geographic details about certain swap transactions. The CFTC believes its proposed procedures are consistent with those used by other agencies for releasing company-specific information.

How would the notional amounts of large swap transactions be disguised in public reports ?

When the CFTC adopted real-time reporting rules for swaps in December 2011, it advised the public that the provisions that mask the size of large swap transactions were placeholders. The CFTC observed that these rules would be modified by new rules once block trade size thresholds are adopted.

The real-time reporting rules disguise the size of a large swap transaction by requiring an SDR to publicly report a CFTC-specified notional value (what the CFTC calls a "notional cap"), even though the true notional size of the transaction exceeds this amount. For example, the CFTC decided that the maximum notional amount that will be reported publicly for a one-year interest rate swap is $250 million. If Party A and Party B enter into a $1 billion one-year interest rate swap, the SDR would report the size of this swap as $250+ million.

The Proposal would override the notional caps provided in the real-time reporting rules and replace them with the new notional caps that would be calculated as follows:

- During the first phase, the maximum notional amount that would be publicly reported would be the greater of the interim maximum cap sizes adopted in the real-time reporting rules or the block trade size threshold for the applicable swap category.
- During the second phase, the notional cap would be set at a level that would mask notional sizes only for swaps comprising the top quarter of the sum total of all notional amounts for the relevant swap category. This would mask notional amounts only for block trades "of significant size." Updated notional caps would be published on the CFTC's website and would take effect on the first day of the second month following the date of publication.

How would the CFTC mask the geographic details of swaps in the other commodity asset class?

To protect the identities, market positions and business transactions of counterparties to certain swaps in the other commodity asset class, the Proposal would require SDRs to limit the geographic detail of the underlying assets of these swaps that is publicly reported. Instead of publicly reporting specific delivery or pricing points, the SDR would report regions, which cover both U.S. and international locations. The regions would vary depending on the specific commodity underlying the swap.