CME Group Market Regulation

Update on Revisions to Rule 538 and Associated Regulatory Guidance

October 13, 2016

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Futures trading is not suitable for all investors, and involves the risk of loss. Futures are a leveraged investment, and because only a percentage of a contract's value is required to trade, it is possible to lose more than the amount of money deposited for a futures position. Therefore, traders should only use funds that they can afford to lose without affecting their lifestyles. And only a portion of those funds should be devoted to any one trade because they cannot expect to profit on every trade. All references to options refer to options on futures.

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Introduction of Presenters

Thomas LaSala, Managing Director & Chief Regulatory Officer

Thomas.LaSala@cmegroup.com; 212.299.2987

Robert Sniegowski, Executive Director, Rules & Regulatory Outreach

Robert.Sniegowski@cmegroup.com; 312.341.5991

Ryne Toscano, Director, Market Surveillance

Ryne.Toscano@cmegroup.com; 212.299.2879

What is an EFRP

General Information

- An Exchange for Related Position (“EFRP”) transaction involves a privately negotiated off-exchange execution of an Exchange futures or options contract and, on the opposite side of the market, the simultaneous execution of an equivalent quantity of the cash product, by-product, related product, or OTC derivative instrument corresponding to the asset underlying the Exchange contract.
- The CME Group Exchanges permit three different types of EFRPs:
- Exchange of Futures for Physical (“EFP”) – the simultaneous execution of an Exchange futures contract and a corresponding physical transaction or a forward contract on a physical transaction.
- Exchange of Futures for Risk (“EFR”) – the simultaneous execution of an Exchange futures contract and a corresponding OTC swap or other OTC derivative transaction.
- Exchange of Option for Option (“EOO”) – the simultaneous execution of an Exchange option contract and a corresponding transaction in an OTC option.

What is an EFRP

General Information

- EFRPs are governed by Rule 538, located in Chapter 5 of each Exchanges' Rulebook, and by the Market Regulation Advisory Notice on EFRPs
- All futures and options on futures are eligible for execution as an EFRP transaction
- Unlike block trades, there are no minimum quantity thresholds applicable to EFRPs
- The price of the Exchange futures or options component of EFRPs are not price reported to the marketplace
- The Exchange component of the EFRP must be submitted to clearing as soon as possible following agreement on the relevant terms by the parties to the transaction
- EFRPs may be transacted at commercially reasonable prices mutually agreed upon by the parties to the transaction. The price of the Exchange component must conform to the applicable futures price increment or option premium increment for the particular product.
- EFRPs may not be priced to facilitate the transfer of funds between parties for any purpose other than as the consequence of legitimate commercial activity.

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What is an EFRP

General Information

- One party to the EFRP must be the buyer of the Exchange contract and the seller of (or the holder of the short market exposure associated with) the related position; the other party to the EFRP must be the seller of the Exchange contract and the buyer of (or the holder of the long market exposure associated with) the related position. The Exchange contract and the corresponding related position must be executed for accounts with the same beneficial ownership.
- The related position component of the EFRP must involve the product underlying the Exchange contract or a by-product, related product or OTC derivative instrument that is reasonably correlated to the corresponding Exchange instrument.
- The quantity of the related position component of the EFRP must be approximately equivalent to the quantity of the Exchange component of the EFRP. Appropriate hedge ratios between the Exchange and related position components of the EFRP may be used to establish equivalency.

Example #1: Invoice Swap Spread

Buy Dec 2016 TY Futures ↔ **Pay Fixed Swap 1 Start: 12/30/2016 Maturity: 8/15/2023**

Treasury Futures privately negotiated off exchange as a package involving a specific matching interest rate swap in the opposing direction.

As of Oct 4, it is also possible to trade packages of multiple invoice spreads as EFRs, including tenor switches and calendar rolls

Example #2: FX OTC Cash/Futures Basis

Buy Dec 2016 Futures ↔ **Sell EUR/USD Spot**

What is an EFRP

General Information

The opposing accounts involved in the execution of an EFRP must be:

- independently controlled accounts with different beneficial ownership; or
- independently controlled accounts of separate legal entities with common beneficial ownership; or
- independently controlled accounts of the same legal entity provided that the account controllers operate in separate business units.

Accounts with the same beneficial ownership include accounts owned by the same person or entity, accounts of a parent and its wholly owned subsidiaries, and accounts of subsidiaries that are wholly owned by the same parent. Common beneficial ownership is more inclusive and includes not only accounts with the same beneficial ownership, but also accounts with common beneficial ownership that is less than 100%.

Parties to an EFRP transaction involving the same legal entity or common beneficial owner must be able to demonstrate the <u>independent control of decision making</u> for the respective accounts and that the EFRP had <u>economic substance for each party to the transaction</u>.

Recent Changes

- Revisions to Rule 538 and the regulatory guidance contained in the MRAN were self-certified with the CFTC on September 19 and are effective as of October 4
- **The revisions include:**
  - Allowing an EFRP to contain multiple Exchange components with different market biases provided it is not a transitory EFRP
  - Allowing any eligible third party to facilitate as principal the related position component of an EFRP
  - Modifying the requirements for CTAs and other account controllers executing immediately offsetting foreign currency EFPs ("IOFXEFPs")
  - Modifying submission time requirements to CME Clearing for the Exchange component of the EFRP
  - Clarifying the responsibility of firms executing or clearing EFRPs on behalf of customers
  - Eliminating the use of summary fines for failure to provide requested records concerning EFRPs to Market Regulation in a complete and timely manner

Recent Changes

EFRPs with Multiple Exchange Components

- Effective on October 4, EFRPs may contain multiple Exchange components provided that the EFRP is not transitory. A transitory EFRP is one where the related positions offset without the incurrence of market risk that is material in the context of the related position transactions
- This replaces an historical prohibition that EFRPs could incorporate multiple Exchange components only if they had the same market bias, or different biases if the Exchange components are legs of a recognized inter-commodity spread involving a physical commodity product and it's by-products (e.g., crack spreads and crush spreads)
- A few examples of transactions that became permissible include:

Invoice Swap Spread Tenor Switch

Buy Dec 2016 10Y Futures	Sell Dec 2016 Bond Futures
Pay Fixed Swap 1 Start: 12/30/2016 Maturity: 8/15/2023	Rec Fixed Swap 1 Start: 12/30/2016 Maturity: 2/15/2036

Cash/Futures Basis Position Roll

Buy Dec 2016 10Y Futures	Sell Mar 2017 10Y Futures
Sell Cash UST Note 1 T 2.5% 8/15/2023	Buy Cash UST Note 2 1.375% 9/30/2023

Recent Changes

Third-Party Facilitation of the Related Position Component of EFRPs

- Under the revised Rule, any third-party will be able to facilitate the related position component of an EFRP on behalf of a customer.

- Except for IOFXEFPs, the third-party must be able to demonstrate that the related position was passed through to the customer who received the Exchange futures or options contract as part of the EFRP.

Recent Changes

Immediately Offsetting FX EFPs (IOFXEFPs)

- For IOFEXPs, CTAs and other investment advisors with discretionary trading authority over client accounts do not need to demonstrate the booking of the two offsetting cash legs to underlying client accounts.
- However, in the event that the futures leg of the IOFXEFP fails to clear, the buy (sell) of the futures and the sell (buy) of the cash are void ab initio
- In that event:
  - The offsetting cash leg (the cash leg with the same directional bias as the futures leg) must continue to exist
  - Previously, CME required the CTA or investment advisor to pass the offsetting cash leg to the client account, requiring that such clients have open cash accounts
  - Under the revisions, we permit the CTA or investment advisor to liquidate the cash leg and pass the resulting profit or loss, if any, to the underlying clients

Recent Changes

Submission Time Requirements

- As of October 4, the Exchanges will require that the Exchange leg(s) of the EFRP be submitted to CME Clearing as soon as possible following agreement to the relevant terms by the parties to the transaction. Absent extenuating circumstances, the EFRP should be submitted on the same day that the relevant terms have been determined.
- This replaces the more prescriptive one-hour requirement for EFRPs executed between 6:00 a.m. and 6:00 p.m. Central Time (for CME and CBOT products) or between 7:00 a.m. and 5:45 p.m. Eastern Time (for NYMEX and COMEX products)
- Market Regulation considers the relevant terms to have been determined at the time the price and quantity of the Exchange contract and the corresponding related position component of the transaction are agreed upon by the parties to the EFRP
- The Exchanges have maintained the exception which permits parties to contractually agree to submit the transaction to CME Clearing once the actual delivery quantity has been precisely determined. Absent such an agreement, the transaction must be submitted to CME Clearing at the time of pricing

Recent Changes

Firm Responsibilities

- Under the revised MRAN, firms that execute or clear EFRPs on behalf of customers should exercise due diligence in identifying circumstances in which a customer's EFRP transactions may be non-bon fide
- Firms that execute or clear EFRPs on behalf of customers are responsible for ensuring that their customers are fully informed regarding Exchange EFRP requirements
- Firms are strongly urged to forward the MRAN to their clients
- Firms should have their clients contact Market Surveillance or Regulatory Outreach in the event they have any questions the firm is unable to answer
- Firms remain responsible for obtaining and providing records of client EFRP transactions in a timely manner when requested by Market Regulation
- Clearing members must take appropriate action if they have notice or knowledge of the execution of non-bona fide EFRPs by their customers
- Account statements must uniquely identify EFRPs – it is not permissible to simply use "ex-pit" or "ClearPort trade" as those terms may denote more than just an EFRP
- Firms may submit EFRPs to CME Clearing via CME Direct/CME ClearPort or via Front-End Clearing (FEC)

Recent Changes

Failure to Provide Market Regulation with Requested Records for EFRPs

- The Exchanges are eliminating the use of summary fines under Rule 512 for a firm's failure to provide requested records to Market Regulation in a ***complete and timely manner***
- Compliance is critically important to Market Regulation's review of selected EFRP transactions
- A failure to respond in a complete and timely manner may result in a recommendation to the Probable Cause Committee that the firm be charged with a violation of Rule 432.L.
- If a charge is issued, the matter will be heard before the Business Conduct Committee
- If the Business Conduct Committee determines the Rule has been violated, sanctions will be imposed accordingly

Q & A

Thank You

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