

# Exchange Amendments to Block Trade Pre-Hedging Rules

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# Administrative Items

The webinar will be recorded and posted to the FIA website following the conclusion of the live webinar.

A question and answer period will conclude the presentation.

- Please use the “question” function on your webinar control panel to ask a question to the moderator or speakers. Questions will be answered at the conclusion of the webinar.

# What's Changed?

- ICE Futures U.S., NASDAQ Futures Inc., CME, CBOT, NYMEX and COMEX eliminated a longstanding prohibition on pre-hedging or anticipatory hedging of a block trade with a single exception
- Pre-hedging/anticipatory hedging remains prohibited when an intermediary takes the opposite side of its own customer order
- ICE's revision became effective 10/31/16
- NASDAQ's revision became effective 11/10/16
- CME Group DCMs revision became effective 11/8/16



# What's Not Changed?

- All the Exchanges continue to prohibit front running of a block trade when acting on material nonpublic information regarding an impending transaction by another person, acting on nonpublic information obtained through a confidential employee/employer relationship, broker/customer relationship, or in breach of a:
  - Fiduciary responsibility (initial language at ICE/CMEG)
  - Pre-existing duty (revised language at ICE/CMEG)

# Terms

ICE and the CME Group Exchanges modified the term “fiduciary responsibility” to “pre-existing duty” at the CFTC’s request.

The CFTC indicated that the term pre-existing duty was used in the Federal Register release on the final rules under Part 180 (Prohibition against manipulation) and was a more appropriate term to use in the context of pre-hedging of block trades.



# Terms

Depending on the facts and circumstances, a person who engages in deceptive or manipulative conduct in connection with any swap, or contract of sale of any commodity in interstate commerce, or contract for future delivery on or subject to the rules of any registered entity, **for example by trading on the basis of material nonpublic information in breach of a pre-existing duty (established by another law or rule, or agreement, understanding, or some other source),** or by trading on the basis of material nonpublic information that was obtained through fraud or deception, may be in violation of final Rule 180.1. (Federal Register Vol. 76, No. 135, July 14, 2011, Page 41403)



# Terms

The Exchanges view the term intermediary in a broad sense. If the party is receiving an order, as opposed to engaging in a discussion or negotiation concerning a potential principal-to-principal transaction, that party is an intermediary, and, accordingly, the intermediary is subject to the pre-hedging prohibition.

In this instance, the pre-hedging prohibition applies directly to the intermediary, in addition to any account which is owned or controlled, or in which an ownership interest is held, including the proprietary account of the employer of such intermediary.



# Hypothetical Scenario

- Assume that A is an eligible contract participant
- It maintains a brokerage relationship with B, a registered futures commission merchant
- B also maintains a proprietary trading desk, C
- D is an affiliate of B that engages solely in proprietary trading



# Q&A on Hypothetical Scenario

If an employee for D initiates or receives a solicitation from A to enter into a futures or related options block trade, D may pre-hedge its block trade as soon as it reasonably believes in good faith that it will enter into the relevant block trade. D will not be acting as an intermediary (i.e., agent) for A but solely as a counterparty.

Correct. This describes a principal-to-principal block trade negotiation wherein pre-hedging is expressly permitted.



# Q&A on Hypothetical Scenario

If an employee for B receives a solicitation from A to execute a block trade, and the employee facilitates the execution of the block either by C or D, neither C nor D may pre-hedge the block trade. Each entity must wait until the block trade is executed before hedging it. This is because B is acting as an intermediary for A.

Correct, in this instance, B has received a customer order and neither C nor D may pre-hedge. Hedging is permissible by C or D only after the block trade has been consummated.



# Q&A on Hypothetical Scenario

An employee of B receives a solicitation from A to execute a block trade. The employee declines the solicitation; however the employee advises A it may contact C or D directly to execute the block. After receiving a solicitation from A directly, C (which is also part of B) or D may pre-hedge its block trade as soon as it reasonably believes in good faith that it will enter into the relevant block trade. C or D will not be acting as an intermediary for A but solely as a counterparty. B is also not acting as an intermediary for A in this transaction.

**Correct. B has declined to intermediate a customer's order and has instead advised the customer to source liquidity directly from C or D. C or D may pre-hedge.**



# Q&A on Hypothetical Scenario

What if C (principal trading desk of B) gets an order from A, and C passes the order to D (prop trading affiliate of C). Can D pre-hedge the order received from C?

If C is acting as an intermediary, as the use of the term “order” suggests, D may not pre-hedge. C may decline to accept the order and either facilitate the execution as a principal or pass A to D. In both those circumstances, C and D would be permitted to pre-hedge.

# Q&A on Hypothetical Scenario

Have you discussed any of these scenarios with the CFTC and, if so, do they share the same views?

CMEG confirmed with the CFTC that the change to “pre-existing duty” did not preclude an intermediary from declining to facilitate the execution of a client’s block order and advising the client to contact the trading desk in a principal-to-principal block trade negotiation. Provided the trading desk had no pre-existing duty, pre-hedging is permissible.

# Questions

May a principal trader receiving a solicitation from a third party to engage in a block trade at a particular price fill a portion of the order (*i.e.*, provided the trade meets or exceeds the minimum size for a Block Trade) and pre-hedge his or her trade(s)?

Yes, provided that the third party has permissioned the trader to execute the block trade in multiple increments, each of which meets the block trade minimum threshold.

# Questions

May the same dealer accept a block trade LIMIT order from a broker from the agency side of the dealer's organization AND pre-hedge his or her trade?

**No. If the agency broker is intermediating the execution of a client's block order, pre-hedging by the firm is not permissible.**

# Questions

Can the same dealer accept a block trade order from a third-party broker (*i.e.*, a broker that is not affiliated with the dealer's FCM or an affiliate of the dealer's FCM), representing the broker's client (not known to the dealer) and pre-hedge that trade?

Yes, provided that the dealer has appropriate industry registration to accept customer orders, pre-hedging in this scenario is permissible. Additionally, the dealer could simply tell the broker that he is willing to trade opposite the broker's client's order and pre-hedge.



# Questions

Are principal salespeople that work within the principal trading framework of a swap dealer considered to be “intermediaries”?

Not for purposes of the principal salesperson facilitating as principal the opposite side of a client’s block trade in Exchange futures or options on futures provided that the salesperson is not accepting or facilitating the execution of a client’s block order in an intermediary capacity.

# Questions

If not, are there any special/additional considerations for principal salespeople that currently hold a Series 3 license with their affiliated registered FCM?

No, provided that if the salesperson is engaging in pre-hedging it is clear to the client that the trade is a principal-to-principal transaction and the salesperson is not intermediating or accepting a client's order.

# Questions

Can the swap dealer salesperson still stay on the phone with the block trading client and not be considered an intermediary, even if the principal trader is conferenced in or joined on the phone too?

Simply being on the phone doesn't make a person an intermediary. If the salesperson is remaining on the line, likely for purposes of discharging clerical responsibilities to get the trade price reported and submitted to clearing, he has not magically become an intermediary.

# Hypothetical Scenario

Further to the definition of “intermediary,” consider the following scenario and related questions: A client calls a futures agency execution desk requesting a block quote. The salesperson on the futures agency desk evidences/communicates to the client that they will be acting in a principal capacity for the purposes of the block trade and will request that a house trader within the firm quote a price on the block trade. The salesperson contacts the house trader for a price which is then relayed back to the client. If the trade is consummated, the trade is reported to the exchange and allocated to the client and house trader’s accounts.



# Q&A on Hypothetical Scenario

Is the salesperson considered an “intermediary” in this scenario where the client understands that the salesperson is acting as a principal?

No, but this trade flow becomes risky based on the fact that the salesperson does have a pre-existing duty to the client when accepting a client’s order. It would be less risky to decline to facilitate the execution and instead direct the client to contact the sales desk directly.

Is the salesperson considered an “intermediary” if the salesperson charges an execution fee?

Absolutely. If the salesperson receives a fee, the Exchanges will have a difficult time concluding the trade was principal-to-principal.



# Questions

If a counterparty calls a salesperson at a proprietary trading desk of a large FCM/B-D, and the salesperson talks to a trader on the same proprietary trading desk, is the marketer considered an “intermediary”?

**No, provided that it is clear to the counterparty that the salesperson is not facilitating the execution of the counterparty’s order by acting as an intermediary.**

# Questions

If Broker A solicits Commercial B (which regularly transacts in central limit order book trading) with a one-sided bid or offer for a block trade and Commercial B has no immediate intention to consummate the block trade, is Commercial B in any way restricted from trading in the central limit order book? If so, for how long? Is the analysis any different depending on whether Commercial B communicates a rejection to Broker A?

Commercial B may continue to trade in the CLOB in the normal course of his business. Commercial B could not trade in the CLOB solely based on the nonpublic information he just received from Broker A. The answer does not change based on the communication of a rejection to Broker A.



# Questions

We note that CMEG's release removes the following two qualifications from its prior MRANs: "This prohibition is not intended to preclude such parties from continuing to transact in the marketplace in the context of their normal business..." and "Information regarding a block trade is considered to be nonpublic until such time that the block trade details...can otherwise be demonstrated to have become stale or obsolete." Was the removal of this guidance intended to effect a change in the meaning of the rule or market conduct?

No





# Questions

For example, are parties solicited to provide a two-sided block market deemed to be in possession of an impending block trade? (We note that this issue is expressly clarified in the CME and Nasdaq releases.)

**No, two-sided quotes are not deemed an “impending block trade.”**

# Questions

What factors will the exchanges consider in assessing whether a market participant in “good faith” believes a position will result from the consummation of the block trade?

The analysis would be completely dependent on the facts and circumstances. The Exchanges would review information concerning the negotiation and would look at the historical activity of the participant.

# Questions

What controls do the exchanges expect to see from an FCM or dealer to prevent incidents of pre-hedging resulting from a broker or dealer unintentionally trading with an affiliated broker from the agency side of the dealer's business?

Firms need to ensure their employees understand when pre-hedging is and is not permitted – training is paramount. Once training is completed, firms should have controls reasonably designed to detect violations and protocols in place to deal with breaches.



# Questions

Please identify the factors you or the CFTC consider relevant to distinguishing between prohibited front running and permissible pre-hedging.

The Exchanges cannot speak for the CFTC. The Exchanges would look at the totality of the facts and circumstances to determine whether there was evidence that a party acted unethically and misused nonpublic information for that party or firm's benefit. Pre-hedging is permitted as a means of facilitating a block trade for a client, not as a means of taking advantage of the client.



# Questions

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**For more information please contact:**

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**FIA**

The logo consists of three characters: 'F', 'I', and 'A'. The 'F' is a solid dark grey block. The 'I' is a solid dark grey vertical bar. The 'A' is composed of several overlapping geometric shapes: a light green triangle on the left, a blue triangle on the right, and a blue horizontal bar at the bottom. The background features a network of thin grey lines forming a grid of irregular polygons.