



Block Trading and EFRP Negotiation, Execution and Documentation

Introduction

Basis of this document

Changes in the regulatory landscape and in market conditions in recent years have seen an increasing demand for cleared transactions, particularly Block trades and Exchange of Futures for (or versus) a Related Position (EFRP). For the purpose of this guidance, an EFRP is reflective of transactions that facilitate the posting of exchange-traded positions versus–Cash/Physical, OTC swap or OTC options. It is also used in this document to reflect any other transaction terminology reflective of any exchange transaction versus a trade in a cash or OTC instrument e.g. a, Basis Trade or Against Actual (AA). Both Block trades and EFRPs result in the posting of exchange traded futures and/or options.

This document is designed to identify the generic requirements for firms involved in the execution of EFRPs and Block trades and highlights specifically what FOA deems to be good practice for these trade types. It must be stated, however, that it remains incumbent on each member firm and/or market participant to independently assess the applicability of relevant rules and the appropriate application of this guidance when measured against its business profile and trading strategy. Exchange rules and guidance may change. This document is subject to specific exchange rules covering this area of activity, but, for the purpose of supporting certain key points in the guidance, we have highlighted references to ICE Futures Europe and CME Group guidance. Note that not all exchanges provide explicit guidance or interpretation of their rules.

Definitions

- **Block trades** (“Blocks”) are bilateral, privately negotiated exchange *futures, options or combination transactions* subject to specific, market-sensitive disclosure, execution and reporting requirements.
- **EFRPs** are transactions where exchange-traded futures contracts and/or exchange-traded options are *posted versus a negotiated and executed Cash/Physical or OTC* transaction or agreement. The Cash/Physical OTC transaction must *first* be executed between parties before any position may be posted (or requested to be posted) on an exchange.

Participants should be aware not only of the generic differences that apply to these definitions, but the related execution, reporting and documentation requirements. The type of trade/order *should*, in the case of Blocks, be identified as *the* specific order type *each* time it is offered to the market insofar as failure to identify a trade type when presenting a bid or offer order may be a breach of exchange rules; each party to a transaction must be aware of the relevant rules under which a transaction is to be executed.

Block Trading

CME Group definition

'Block trades are privately negotiated futures, options or combination transactions that meet certain quantity thresholds which are permitted to be executed apart from the public auction market.' (CME Group Definition (Rule 526))

As a specific futures order type, Blocks are subject to the relevant exchange rule book. For some exchanges you need to be a member to negotiate and report Block trades and for others there may be no membership requirement. The qualification to trade Blocks is usually determined by the relevant exchange and anyone wishing to undertake this task should refer to the exchange rules. Generally speaking, Blocks may only be entered into by 'professional' entities and not retail clients.

Key Requirements

Members may wish to consider the following points when executing Blocks:

- Do you require prior consent from a client to request (or offer) a quotation as a Block, or to manage an order as a Block?
- What are the requirements and prohibitions for block trading on the relevant exchange?

Example

"Parties involved in the solicitation and negotiation of a block trade may not disclose details of those negotiations to any other party, other than to facilitate the execution of the Block."(CME Group Guidance (at 25th April 2013))

- Do you require permission to disclose the identity of a client involved in the negotiation of a Block to any party (e.g. the express consent of a client) and is it restricted to only your counterparty?
- Are you required to disclose that an RFQ or an order is a Block RFQ or order when you seek to execute on behalf of a client? (You should note that there may be specific exchange requirements governing the negotiations of a Block).
- When offering a Block bid or offer, it should be identified as such each time it is offered to a potential matching client/counterparty.

Example

- ***"On each occasion of quoting a Block Trade price, the Member must, at the time, make it clear to the potential counterparty(ies), whether a Member or a client who is not a Member of the Exchange, that the price being quoted is a Block Trade price and is not the prevailing Market price."*** (ICE Futures Europe Block Guidance (as at April 25th 2013))
- Are Block bids/offers permitted to be offered simultaneously to multiple potential clients/counterparties without express permission of the originating clients or must they be negotiated bi-laterally under the relevant exchange rules? (NB. Exchanges may give capacity for firms to place ***"indicative"*** Block bids/offers on multilateral platforms, but Blocks may not be ***executed*** on an MTF or other electronic platform).
- 'Pre-hedging', i.e. establishing a position in anticipation of a Block trade, or trading based on the knowledge of a Block trade is prohibited.

Example

Pre-hedging or anticipatory hedging of any portion of a block trade in the same product or a closely-related product based upon a solicitation to participate in a block trade is not permitted. A closely related product is a product that is highly correlated to, serves as a substitute for, or is the functional economic equivalent of the product being traded as a block” (CME Group Guidance (at 25th April 2013))

- Executed Block trades should be reported to the relevant market within a stipulated time after execution agreement. This period is usually 5 minutes or 15 minutes, dependent on contract type and/or time of day (reflecting execution either inside or outside regular trading hours). The reporting period enables parties to the trade to execute any hedging activity. Information regarding a consummated Block trade is considered **non-public** until such time as the Block is published to the market.

Documentation

Documentation requirements for Block trades are as per any other futures transaction in terms of a full audit trail process and in accordance with the relevant exchange requirements.

EFRP Trading

EFRPs are OTC transactions against which exchange futures/options contracts are exchanged, principally to hedge the corresponding OTC transaction. Some exchanges allow participants flexibility with regard to the underlying documentation requirements, whereas others only require basic evidence of an OTC agreement. Others may require full ISDA-based Long Form Confirmation documentation and evidence of market risk. Particularly, as in the case of “transitory” or “contingent” EFRP trades (where offsetting OTC transactions and an exchange posting against one of the OTC trades may be agreed, either simultaneously or subsequent to the execution of an existing OTC trade) some transactions may only be permitted on some exchanges in relation to certain contracts i.e. reference must always be made to Exchange rules.

- Parties are responsible negotiating and agreeing the OTC transaction prior to any request to post futures to the exchange.
- Each party to the OTC transaction should be disclosed to each other and, where appropriate and relevant, be accompanied by KYC/AML due diligence on each other. Without such disclosure and due diligence, the OTC agreement and execution may constitute a breach of regulatory requirements
- Where a participant has provided a broker with a list of counterparties with whom they are able to execute on an OTC basis, the broker may have capacity to execute the EFRP transactions via a screen bid/offer without first disclosing counterparty identity. Confirmation of the OTC transaction, including the counterparty name, should be provided to each party subsequent to any EFRP execution on screen.

Documentation

Whatever the particular requirements, EFRP and Block transactions should be documented appropriately and capture the OTC details in accordance with the relevant exchange requirements. As indicated, these may differ but as a general guide:

- Trade recaps and confirms should clearly identify the buyer and seller of the OTC transaction and not just the clearing entity acting as the central counterparty;

- Additional language may be required in documentation to identify the nature of the EFRP or Block (e.g. to reflect a contingent element to the OTC transaction(s) and should at all times reflect the requirement of the specific exchange and contract)

Useful examples of Exchange guidance

ICE Futures Europe Guidance (at 25th April 2013)

- Utility and emissions contracts and Oil options:

“...evidence of any swap or option transaction is acceptable, including where the swap or option has been bilaterally negotiated with the express purpose of acceptance for clearing by the Exchange. This includes simple agreements to transact the option deal and clear it via submission to the Exchange.” (Ice Futures Europe Guidance as at 25th April 2013)

- Oil futures contracts (not “swap futures”):

“Evidence of a bona fide pre-existing physical or swap agreement that is not dependent on the transaction being registered as an ICE Futures Europe EFS. This cannot be a ‘contingent’ EFS – the OTC swap leg must not be retrospectively cancelled out by a further linked swap that comes into effect if the trade is accepted by the Exchange as an EFS” and “Each swap leg must be able to stand alone if executed singly, and must bear genuine economic risk.” (Ice Futures Europe Guidance as at 25th April 2013)

CME Group EFRP Documentation Rule 538)

- Cash, OTC swaps, OTC option or other OTC derivatives

“Parties to any EFRP transaction must maintain all documents relevant to the Exchange contract and the cash, OTC swap, OTC option, or other OTC derivative, including all documents customarily generated in accordance with relevant market practices and any documents reflecting payment and transfer of title. Any such documents must be provided to the Exchange upon request, and it shall be the responsibility of the carrying clearing member firm to provide such requested documentation on a timely basis.”

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