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Package Transactions – A Way Forward[1]

As the Commodity Futures Trading Commission ("Commission" or "CFTC") continues to develop its regulatory framework for the mandatory trade execution of swaps pursuant to Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"),[2] so called "package transactions" present a fundamental and critical challenge—how to balance the competing goals of encouraging trading and price discovery on centralized markets while at the same time permitting more customized, complex and efficient transactions to occur.

The trading of swaps matured in a non-regulated environment which permitted many such transactions to be constructed in a manner to maximize their utility without consideration of regulatory constraints. Other forms of package transactions were accommodated under an existing regulatory framework which applied to only one of the legs of the package transaction. For example, the regulated futures markets accommodated certain swap package transactions through "exchange-of-futures-for-swaps" transactions. The Commission faces a critical challenge in how to bring such useful transactions within the new swaps regulatory framework in a manner that preserves their economic utility. Failure to do so could compromise the public interest in the provision of "a means for managing and assuming price risk."[3] The regulatory challenge posed by package transactions is how to balance these competing regulatory objectives.

The Commission should look for a solution to analogous precedent in the futures and securities markets. Both the Commission and the Securities and Exchange Commission ("SEC") have successfully navigated this issue previously. In particular, in crafting a more permanent solution for package transactions, the Commission should be guided by its past precedent under which complex multi-component transactions have successfully traded in the futures markets for decades. This article explains and reviews the status of and challenges facing package transactions, and then explores analogs in both the futures and securities markets that could act as models for Commission action in this area. Specifically, we suggest that the Commission look for guidance to the treatment of exchanges for related positions in the futures markets and qualified contingent trades in the equity securities markets.

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[2] Pub. L. 111-203, 124 Stat. 1376 (2010).

[3] 7 U.S.C. § 5.

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I. Background

Section 2(h)(8) of the Commodity Exchange Act ("CEA"),[4] added by the Dodd-Frank Act, requires that transactions involving swaps subject to the clearing requirement under section 2(h)(1) of the CEA be executed on a designated contract market ("DCM") or swap execution facility ("SEF"), unless no DCM or SEF makes such swaps available to trade or such swaps qualify for an exception from the clearing requirement. In 2013, the Commission adopted rules to implement the trade execution requirement of section 2(h)(8).[5] The rules specify procedures for DCMs and SEFs to make a swap that is subject to the trade execution requirement available to trade. To date, the Commission has issued five made-available-to-trade ("MAT") determinations for certain interest rate and credit default swaps under § 40.6 of the Commission's regulations.[6]

All MAT swaps subject to the trade execution requirement must be executed on a DCM or SEF in accordance with prescribed execution methods. Such swaps that are traded on a SEF are defined as "required transactions."[7] Required transactions that are not block trades must be executed on the SEF either by means of an Order Book or a Request for Quote System that operates in conjunction with an Order Book.[8] The mandatory execution methods for swaps executed on a SEF are set forth in § 37.9 of the Commission's regulations.[9] On a DCM, swaps subject to the trade execution requirement must be executed pursuant to subpart J of part 38 of the Commission's regulations,[10] which implements DCM Core Principle 9 under section 5(d)(9) of the CEA, as amended by the Dodd-Frank Act.[11]

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[4] 7 U.S.C. § 2(h)(8).

[5] Process for a Designated Contract Market or Swap Execution Facility to Make a Swap Available to Trade, Swap Transaction Compliance and Implementation Schedule, and Trade Execution Requirement Under the Commodity Exchange Act, 78 *Fed. Reg.* 33606 (June 4, 2013).

[6] 17 C.F.R. § 40.6.

[7] 17 C.F.R. § 37.9(a)(2).

[8] These terms are defined in 17 C.F.R. § 37.3(a)(3).

[9] 17 C.F.R. § 37.3(a).

[10] 17 C.F.R. § 38.500 Core Principle 9.

[11] 7 U.S.C. § 7(d)(9). Regulation § 38.500 Core Principle 9 provides:

> The board of trade shall provide a competitive, open, and efficient market and mechanism for executing transactions that protects the price discovery process of trading in the centralized market of the board of trade. The rules of the board of trade may authorize, for bona fide business purposes:
>
> (a) Transfer trades or office trades;
>
> (b) An exchange of:
>
> (1) Futures in connection with a cash commodity transaction;
>
> (2) Futures for cash commodities; or
>
> (3) Futures for swaps; or
>
> (c) A futures commission merchant, acting as principal or agent, to enter into or confirm the execution of a contract for the purchase or sale of a commodity for future delivery if the contract is reported, recorded, or cleared in accordance with the rules of the contract market or a derivatives clearing organization.

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Not surprisingly, the trade execution requirement is proving to be particularly challenging for "package transactions," i.e., transactions priced together involving more than one swap or financial instrument where at least one component swap is subject to the trade execution requirement. Package transactions risk being broken up if one or more of the swaps, but not all the financial instruments comprising the package, must be executed on a DCM or SEF pursuant to the mandatory execution methods.

Market participants have pointed to myriad hurdles in connection with DCM or SEF execution of package transactions, which differ in applicability and severity depending on the type of package transaction. There are many different categories of package transactions, usually dependent on the non-MAT swap components. These may, for example, be securities, futures, or mixed swaps. Obstacles to DCM or SEF execution include the lack of adequate infrastructure to process package transactions, and issues relating to clearing, price reporting, screening of credit limits, simultaneous acceptance of all legs of a package transaction, and treatment of securities or futures components.

II. Commission Action and Reaction

Commission staff recognize "the commercial utility of package transactions,"[12] and have acknowledged the complexities raised by market participants, but so far they have declined to provide the indefinite relief requested. Instead, staff have issued a series of no-action letters granting time-limited relief to certain categories of package transactions, where a package transaction is defined as:

> A transaction involving two or more instruments: (1) that is executed between two or more counterparties; (2) that is priced or quoted as one economic transaction with simultaneous or near simultaneous execution of all components; (3) that has at least one component that is a swap that is made available to trade and therefore is subject to the CEA section 2(h)(8) trade execution requirement; and (4) where the execution of each component is contingent upon the execution of all other components.[13]

In February 2014, the CFTC's Division of Market Oversight ("DMO") first issued time-limited relief from the mandatory trade requirement until May 15, 2014[14] to entities and counterparties transacting package transactions as well as to DCMs and SEFs facilitating trading in one or more components of a package transaction.

Shortly after publication of CFTC Letter No. 14-12, the DMO hosted a public roundtable on execution issues relating to package transactions, which highlighted the complexities inherent in subjecting package transactions with a MAT swap component to the trade execution requirement. At the end of the relief period and in response to the roundtable and

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[12] CFTC DMO, Letter No. 14-12, "No-Action Relief from the Commodity Exchange Act Sections 2(h)(8) and 5(d)(9) and from Commission Regulation § 37.9 for Swaps Executed as Part of a Package Transaction," Feb. 10. 2014 ("CFTC Letter No. 14-12"). *But see,* "Core Principles and Other Requirements for Swap Execution Facilities; Final Rule," 78 *Fed. Reg.* 33476, 33494, note 222 (Jun. 4, 2013) ("SEF Final Rules"), suggesting that a broad exemption for package transactions "could undermine the trade execution requirement by allowing market participants to execute swaps subject to the trade execution requirement bilaterally rather than on a SEF or DCM."

[13] CFTC DCO and DMR, Letter No. 14-62, "No-Action Relief from the Commodity Exchange Act Sections 2(h)(8) and 5(d)(9) and from Commission Regulation § 37.9 for Swaps Executed as Part of Certain Package Transactions and No-Action Relief for Swap Execution Facilities from Compliance with Certain Requirements of Commission Regulations § 37.9(a)(2), § 37.203(a) and § 38.152 for Package Transactions," May 1, 2014 ("CFTC Letter No. 14-62").

[14] CFTC Letter No. 14-12. In this first no-action letter, staff included a slightly different definition of "package transactions." Under the earlier definition, a package transaction must have been executed between two (rather than two or more) counterparties and must have had simultaneous execution of all components (rather than simultaneous or near simultaneous execution).

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continued industry urging, the DMO, together with the Division of Clearing and Risk ("DCR," and together with the DMO, the "Divisions") issued CFTC Letter No. 14-62 in May 2014, extending and expanding the February relief for several categories of package transactions.[15] Portions of the relief granted by the Divisions have already expired, e.g., for transactions in which each component of the package is a swap subject to the trade execution requirement, or one or more of the components is a MAT swap and the other(s) is/are subject to mandatory clearing. Other relief was recently extended in phases as described below.[16]

In addition, in a separate no-action letter in September 2014, the Divisions granted conditional relief to DCMs and SEFs until February 16, 2015 from the prohibition on prearranged trading under § 38.152 of the Commission's regulations if, after one leg of a package transaction has been rejected for clearing, the DCM or SEF permits a new trade, with terms and conditions that match the terms and conditions of the original trade (other than the time of execution), to be submitted for clearing, i.e., a so-called "new trade, old terms" procedure.[17]

The time-limited relief currently in place for package transactions, in accordance with CFTC Letter No. 14-137, is as follows:

(1) For **"MAT/Agency MBS"** package transactions (comprised exclusively of at least one MAT swap and agency mortgage-backed securities), until **May 15, 2015**, the swap components subject to the trade execution requirement are not required to be executed on a DCM or SEF. During that time, DCMs and SEFs may offer any method of execution for these component swaps, i.e., a trading system, facility, or platform. Entities or counterparties must execute the component swaps through any method offered on a DCM or SEF.

(2) For **"MAT/New Issuance Bond"** package transactions (comprised of at least one MAT swap and at least one bond issued and sold in the primary market), until **February 12, 2016**, the swap components subject to the trade execution requirement are not required to be executed on a DCM or SEF and DCMs or SEFs may offer any method of execution. In addition, SEFs also are not required to offer an Order Book as a minimum trading functionality for the component swaps.

(3) The same relief was granted until **November 14, 2015** for "**MAT/Futures"** package transactions (comprised exclusively of at least one MAT swap and one or more futures contracts). Examples include MAT swap vs. Treasury futures, and MAT swap vs. Eurodollar futures.

(4) Relief from execution on a DCM or SEF pursuant to CEA section 2(h)(8) was granted until **February 15, 2015** and for mandatory execution method and the Order Book requirement until **February 12, 2016** for:

   a) **"MAT/Non-MAT (Uncleared)"** package transactions (comprised of at least on MAT swap and at least one CFTC swap not subject to mandatory clearing). Examples of instruments in this category are MAT swap vs. swaption, and MAT swap vs. uncleared credit default swap.

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[15] CFTC Letter No. 14-62.

[16] CFTC DCO and DMR, Letter No. 14-137, "Extension of No-Action Relief from the Commodity Exchange Act Sections 2(h)(8) and 5(d)(9) and from Commission Regulation § 37.9 and Additional No-Action Relief for Swap Execution Facilities from Commission Regulations § 37.3(a)(2) for Swaps Executed as Part of Certain Package Transactions," Nov. 10, 2014 ("CFTC Letter No. 14-137").

[17] CFTC DCO and DMR, Letter No. 14-121, "Extension of No-Action Relief for Swap Execution Facilities and Designated Contract Markets from Compliance with Certain Requirements of Commission Regulations § 37.9(a)(2), § 37.203(a) and § 38.152 for Package Transactions," Sep. 30, 2014 ("CFTC Letter No. 14-121"). *See also* CFTC Letter No. 14-137, note 4.

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b) **“MAT/Non-Swap Instruments”** package transactions (comprised of at least on MAT swap and at least one non-swap). Examples include MAT swap vs. single-name credit default swap, and MAT swap vs. bond (secondary market transaction). Excluded from this category are U.S. Dollar Swap Spreads, MAT/Futures, MAT/Agency MBS, and MAT/New Issuance Bond (which fall under different package transaction categories.

c) **“MAT/Non-CFTC Swap**” package transactions (comprised of at least one MAT swap and at least one swap over which the CFTC does not have exclusive jurisdiction), e.g., a mixed swap.

III. Challenges Will Remain After Expiration of the Temporary Relief

In many respects, the Commission’s no-action relief is only kicking the can down the road. Each type of package transaction for which the Commission has granted temporary relief will continue to face instrument-specific hurdles beyond the fundamental one that no SEF lists these packages or is yet in a position to make them available to trade. These challenges likely will require a regulatory response that goes beyond allowing market participants more time.

For example, CFTC swaps that are not currently subject to mandatory clearing, e.g. swaptions, also are not currently subject to the trade execution requirement or to certain documentation and disclosure requirements. These swaps often involve counterparty-specific pricing and have not been through any liquidity review to determine if they are suitable for a MAT determination. It is unclear the extent to which market participants could resolve these issues by the end of the no-action relief period.

In addition, package transaction categories that include one or more components that are securities (including security-based swaps) raise substantial jurisdictional and regulatory issues since the securities components of package transactions (e.g., mortgage-backed securities or single name credit default swaps) are subject to the jurisdiction of the SEC and not of the CFTC and are generally prohibited from being traded on a non-securities exchange or trading platform.[18] It remains unclear how package transactions with a security component will be able to be executed, especially since the SEC’s regime for dually-registered SEFs is not yet in place.

Package transactions that include futures similarly raise regulatory issues. First, SEFs are prohibited by Commission rules from listing futures contracts, which may only be listed on a DCM. Thus, SEFs may not execute all components of the package transaction on-exchange, forcing the package to be broken up. Second, certain DCMs are preventing market participants from executing an exchange of derivative for related position (“EDRP”)[19] if a related swap is executed on a SEF. For example, the Chicago Mercantile Exchange (“CME”) recently adopted CME Rule 538, which prohibits a swap executed on a SEF from being exchanged as part of an EDRP transaction on the CME,[20] thus effectively precluding the MAT component of a MAT/Futures package transaction from being the related position component for an EDRP transaction.

IV. The Commission Should Consider Futures and Securities Precedents for a Longer-Term Solution

Precedent exists under both the futures and securities regulatory regimes for dealing effectively with transactions that are comprised of more than one financial instrument. Under these regimes, certain qualifying transactions are either exempted from the rules that effectively preclude their execution (e.g., the SEC’s exemption for qualified contingent

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[18] Section 5 of the Securities Exchange Act makes it unlawful for any broker-dealer or exchange directly or indirectly to effect a securities transaction on an exchange unless the exchange is registered as a national securities exchange or exempt from registration. 15 U.S.C. §78e.

[19] The Commission has proposed referring to all exchanges for related positions, which may not include a swap component, as exchanges of derivatives for related positions (“EDRPs”). Accordingly, we use the term “EDRP” throughout this article.

[20] See CME Rule 538 (see http://www.cmegroup.com/rulebook/files/ra1311-5r.pdf).

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trades from its order protection rule) or by allowing them to be executed away from but subject to the rules of the relevant exchange (e.g., permitted treatment of EDRPs). While neither the futures nor the securities precedent is a perfect analog to package transactions, the approaches taken by the SEC and CFTC respectively in those areas demonstrate the workability of permitting off-exchange transactions and can serve as a model for the crafting of effective long-term Commission relief for package transactions. Instead of continuing to grant piecemeal short-term no-action relief, the Commission should instead consider amending Part 37 of its rules to permit SEFs to adopt rules establishing procedures permitting package transactions to be arranged outside of the facilities' Order Book.[21]

A. Looking to Futures – EDRPs

In the futures markets, an exchange for related position is, and has been since passage of the Commodity Exchange Act of 1936, a Congressionally-approved process for bringing off-market transactions that link the cash or over-the-counter ("OTC") bilateral markets with the exchange-traded futures markets. Indeed, inclusion of exchange-of-futures-for-physicals transactions in the Commodity Exchange Act of 1936 codified a then long-standing practice in the futures markets.

Section 5(d)(9) of the CEA provides that, in order to be designated as a contract market, boards of trade must:

> provide a competitive, open, and efficient market and mechanism for executing transactions that protects the price discovery process of trading in the centralized market of the board of trade. . . . The rules of the board of trade may authorize, for bona fide business purposes . . . an exchange of—(I) futures in connection with a cash commodity transaction; (II) futures for cash commodities; or (III) futures for swaps . . . .[22]

Commission Regulation § 1.38, dealing with execution of transactions, requires "open and competitive" execution of futures and commodity options on an exchange.[23] Prearranged transactions are thus generally prohibited. But, consistent with section 5(d)(9), this requirement does not apply to transactions that are executed "non-competitively," i.e., off-exchange, in accordance with written rules of the contract market that have been approved by the Commission.[24] EDRPs have been successfully traded off-exchange under this framework for decades as approved exceptions to the general prohibition in futures markets against prearranged transactions.

An EDRP is a type of privately-negotiated futures transaction, generally limited to eligible market participants, that involves separate but integrally-related transactions in the same or a related commodity. An EDRP is executed off-exchange, but subject to the rules of the exchange, and it must be reported to the exchange within the prescribed time. EDRPs are a process for facilitating a transaction in which a futures contract is exchanged for an economically offsetting position in a related cash commodity or OTC derivative. An EDRP transaction consists of a buyer of a cash contract or a derivative who is the seller of the corresponding related exchange position, and a seller of a cash

[21] As discussed below, although section 5h of the Act does not explicitly require the Commission to recognize EDRP transactions as does Core Principle 9 with respect to DCMs, nothing in section 5h precludes the Commission from incorporating similar concepts and procedures for swap contracts executed subject to the rules of a SEF or DCM. The Commission has concluded that it has authority to adopt an exemption for various types of package transactions under section 5h of the Act. *See*, SEF Final Rules, 78 *Fed. Reg.* at 33494. If the Commission were to conclude that it lacked authority under section 5h to amend its Part 37 rules in this manner, nothing precludes the Commission from using its section 4(c) exemptive authority to reach a similar result.

[22] 7 U.S.C. § 5(d)(9); *see* Commission Regulation § 38.500, *supra* note 11. Section 5(d)(9) was amended by the Dodd-Frank Act to add the requirement that an EDRP be for "bona fide business purposes."

[23] 17 C.F.R. § 1.38(a) .

[24] *Id.*

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contract or derivative who is the buyer of the corresponding exchange position. The CME describes EDRPs as follows:

> An [EDRP] transaction involves the off-exchange execution of an Exchange futures or options on futures 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.[25]

EDRPs enhance price discovery by providing an additional mechanism for tying the cash and derivatives markets to the futures markets, enhancing transparency as transaction details are publicized and reducing counterparty credit risk by bringing bilateral cash or derivative market obligations to be cleared by a central clearing counterparty.

There are several different types of EDRPs, including exchanges for physical or cash commodities ("EFPs"), in which a position in the underlying physical instrument is exchanged for a corresponding futures position; exchanges for swaps ("EFSs"), in which a cash settled swap contract is exchanged for a physical delivery futures contract; exchanges of OTC options for exchange-traded options ("EOOs"), in which a position in an OTC option (or other OTC contract with similar characteristics) in the same or related instrument is exchanged for an option position; and exchanges for risk ("EFRs"), in which a position in an OTC swap or other OTC derivative in the same or related instrument is exchanged for the corresponding futures contract.

EDRPs have long been a mechanism for bringing off-market transactions to the centrally-traded and cleared futures markets at a negotiated price consistent with commercial market realities. They have also provided commercial market participants more flexibility as to their delivery options than can be provided by standardized exchange delivery terms. In fact, EDRPs have been a common and readily accepted market transaction for more than 75 years, their use pre-dating the CEA. In 1920, while observing grain trading at the Chicago Board of Trade, the Federal Trade Commission noted the acceptance of EFPs as a bona fide form of ex-pit, i.e., off-exchange, transaction.[26] In 1936, when Congress adopted the CEA, it included section 4c(a), which in relevant part explicitly permitted EFPs, stating that:

> Nothing in this section shall be construed to prevent the exchange of futures in connection with cash commodity transactions or of futures for cash commodities, . . . if made in accordance with board of trade rules applying to such transactions and such rules shall have been approved by the Commission.

Congress included this provision in recognition that "the exchange of cash commodities for futures is a common and necessary practice."[27]

The Commission in 1998 issued a Concept Release to consider the regulation of off-market transactions, including EDRPs.[28] After a number of intervening studies and proposals, the Commission in 2010 as part of its implementation of the amendments to the CEA by the Dodd-Frank Act, proposed Commission Regulation § 38.505.[29] Regulation § 38.505, which remains pending, will codify the principles first articulated in the 1998

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[25] CME Group Advisory RA1311-5, Q1.

[26] Report of the Federal Trade Commission on the Grain Trade, Vol V, at 146-48 (1920).

[27] Commodity Short Selling, H.R. Rep. No. 1551, 72d Cong., 1st Sess. 3 (1932). As discussed further below, the relevant language in section 4a(c) of the Act remained substantially unchanged until the passage of the Commodity Futures Modernization Act of 2000 ("CFMA"), when the provisions recognizing EDRPs were transferred from CEA section 4a and to new Core Principle 9 for designated contract markets ("DCMs").

[28] Regulation of Noncompetitive Transactions Executed on or Subject to the Rules of a Designated Contract Market, 63 *Fed. Reg.* 3708 (Jan. 26, 1998) ("Concept Release").

[29] Core Principles and Other Requirements for Designated Contract Markets, 75*Fed. Reg.* 80572 (Dec. 22, 2010).

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Concept Release, which establish the requirements for a bona fide EDRP transaction (consistent with section 5(d)(9) of the CEA).

Under proposed Regulation § 38.505(a)(2), a bona fide exchange of derivatives for related positions transaction must include separate but integrally related transactions involving the same or a related commodity, where there is a price correlation and quantitative equivalence between the derivative and related position legs, and a buyer of a derivative who is the seller of the corresponding related position, and a seller of a derivative who is the buyer of the corresponding related position. In addition, the proposed rule provides that EDRPs must result in an actual transfer of ownership of the related position, which must take place between parties with different beneficial owners or, if between affiliates, between affiliates under separate control. The proposed rule would also require that the price differential between the futures leg and the commodities or derivatives leg or position reflect commercial realities, and at least one leg of the transaction should be priced at the prevailing market price.[30]

Just as with bona fide EDRPs, the Commission could create an exemption from the SEF Order Book requirement for package transactions that meet specified criteria which is designed to meet the objectives of the trade execution requirement while at the same time facilitating execution of all components of the transaction as a package. The long and well-travelled history of EDRPs can provide the Commission with a familiar path towards an effective exemption, which has the benefit of over 75 years of experience and understanding.[31]

B. Looking to Securities – Qualified Contingent Trades

The Commission could also look for a guidepost to an SEC exemption from the order protection rule for contingent trades. In the context of equity securities, certain qualified "contingent trades" are exempt from the inter-market trade-through requirement under Rule 611(a) of the SEC's Regulation NMS, also known as the order protection rule.[32] Similar to package transactions, a contingent trade is a multi-component transaction involving orders for a security and a related derivative, or orders for related securities, that are executed at or near the same time, where the execution of the one order is contingent upon the execution of the other, and the economics of which are based on the relationship between the prices of the components. The transactions are dependent on the spread or ratio between the prices for each of the components and not on the price of any single component. The parties to a contingent trade will not execute one side of the trade without the other component or components also being executed in full (or partially, at a predetermined ratio) and at the specified spread or ratio. Because of this, the price of any single component may not correspond to the prevailing market price of that component.

Rule 611 of Regulation NMS[33] provides inter-market price priority for displayed and accessible quotations in NMS stocks, i.e., any security or class of securities, other than an option, for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan.[34] Rule 611 requires, among other things, that trading centers establish, maintain, and enforce written policies and procedures reasonably designed to prevent "trade-throughs." A trade-through is an execution of a trade at a price inferior to a protected quotation displayed

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[30] *See* Proposed Regulation § 38.505(a)(2).

[31] *See* CME Rule 538 and Advisory RA 1311-5 (Apr. 14, 2014). As discussed in section III above, recent CME Rule 538 now prohibits a related position in an EDRP transaction from being a swap that is traded on a DCM or SEF. If the Commission were to permit package transactions to be executed off exchange, this concern would no longer be relevant for MAT/Futures package transactions that may also be EDRPs.

[32] 17 C.F.R. 242.600 et seq.

[33] 17 C.F.R. 242.611(d).

[34] See 17 C.F.R. § 242.600(b)(46) and (47).

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by another trading center. A protected quotation is one that is immediately and automatically accessible.

If the designated price of an NMS stock that is a component of a contingent trade is inferior to a protected bid or offer, Rule 611 would require that the better protected bid or offer be satisfied before execution of the NMS stock component of the contingent trade. This effectively prevents the contingent trade from being executed in accordance with its original terms. Breaking the transaction into its separate components would allow execution of the NMS stock at the protected price but would effectively negate the trading or hedging strategy underlying the contingent trade, leaving the parties to trade "out of hedge," necessitating additional transactions to try to correct the imbalance.

The SEC has recognized that contingent trades could become "too risky and costly to be employed successfully if they were required to meet the trade-through provisions of Rule 611," and thus, a year after adoption of Regulation NMS, it granted a qualified contingent trade exemption for any trade-throughs caused by the execution of an order involving one or more NMS stocks that are components of a qualified contingent trade.[35] A qualified contingent trade was defined in the QCT Exemptive Order, as later modified, as a transaction consisting of two or more component orders, executed as agent or principal, where:

(1) at least one component order is in an NMS stock;

(2) all components are effected with a product or price contingency that either has been agreed to by the respective counterparties or arranged for by a broker-dealer as principal or agent;

(3) the execution of one component is contingent upon the execution of all other components at or near the same time;

(4) the specific relationship between the component orders (e.g., the spread between the prices of the component orders) is determined at the time the contingent order is placed;

(5) the component orders bear a derivative relationship to one another, represent different classes of shares of the same issuer, or involve the securities of participants in mergers or with intentions to merge that have been announced or since cancelled; and

(6) the Exempted NMS Stock Transaction is fully hedged (without regard to any prior existing position) as a result of the other components of the contingent trade.[36]

Any trading center that meets these conditions qualifies for the exemption and is permitted to execute the NMS component of a qualified contingent trade without having to comply with the order execution rule.

Just as the long history of EDRPs may be helpful to the Commission in its consideration of a package transaction exemption, so too can the qualified contingent trade exemption provide some guidance.

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[35] Securities Exchange Act Release No. 54389 (Aug. 31, 2006), 71 *Fed. Reg.* 52829 (Sep. 7, 20116) ("QCT Exemptive Order").

[36] A size condition based on block size was removed from the qualified contingent trade definition in a later order modifying the QCT Exemptive Order, Securities Exchange Release No. 57620 (Apr. 4, 2008) ("Modified QCT Exemptive Order"). The SEC agreed with the requesting party (the Chicago Board Options Exchange, Inc.) that the size limitation unnecessarily served to inhibit retail investors from engaging in buy-write transactions of modest size and indeed was not necessary to achieve the objectives of Rule 611.

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V. Conclusion

The Commission has recognized the commercial importance of package transactions. Because challenges to their execution likely will remain after the staff's no-action relief has expired, the Commission will continue to grapple with finding a solution. We believe the Commission can benefit from the lessons learned from the more than 75 years of EDRP transactions in the futures markets as well as the SEC's similar experience in connection with qualified contingent transactions and incorporate that learning into a permanent rule framework or exemption for package transactions that would allow them to be executed off but subject to the rules of a DCM or SEF.

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