

## Cabinet News and Views

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### Enhancing Disclosure Requirements for Derivatives



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Two settled enforcement actions in April 2023 indicate that the Commodity Futures Trading Commission (“CFTC”) is expecting increased swaps disclosure by swap dealers under the Dodd-Frank Act of 2010 and applicable CFTC regulations.

In the first enforcement action, the CFTC sanctioned a U.S. swap dealer for failing to comply with CFTC Regulation § 23.431, which requires a swap dealer, among other things, to provide pre-trade mid-market marks (“PTMMM”) before each transaction to allow its non-swap dealer counterparties to “make their own informed decisions about the appropriateness of entering into the swap.” Pre-trade mid-market marks are intended to represent an “objective value,” providing counterparties with “a baseline to assess swap valuations.”

The CFTC found that the swap dealer had transacted dozens of “same-day” equity index swaps with U.S.-based clients and failed to disclose to clients the PTMMM of these swaps. In a “same-day” equity index swap, the equity leg of the swap strikes on the “same day” as the other material terms of the swap are agreed upon, rather than – as is typical – the day after the date of agreement. The CFTC found that the swap dealer often disclosed a PTMMM for a different swap (the analogous “T+1” swap, not the “same-day” swap), thereby obscuring the value of the same-day swap.

Although academic and somewhat arbitrary, PTMMM are clearly important in the CFTC’s view of a swap dealer’s obligation to communicate in “a fair and balanced manner based on principles of fair dealing and good faith” under applicable CFTC rules.

In the second enforcement action, the CFTC sanctioned a U.S. swap dealer for failing to adequately disclose to its non-swap dealer swap counterparties the effects of the swap dealer's pre-hedging in connection with certain foreign exchange forward transactions. (We note that in the block futures context, which is different from swaps, pre-hedging by intermediaries is actually prohibited in certain circumstances.)

This swap dealer entered into a number of deal-contingent foreign exchange ("DCFX") forwards for customers who would need foreign currency if an unrelated financing were to close; as such, these transactions were very time-sensitive and typically involved large sums of foreign currency. Upon being instructed to execute the DCFX forward, the swap dealer would pre-hedge in the open market "in the minutes or seconds" before executing the customer transaction. The CFTC found that the swap dealer did not adequately disclose to customers that the swap dealer's pre-hedging practices may have resulted in less favorable exchange rates.

The CFTC found violations of three of its swap dealer business conduct standards regulations, specifically § 23.431(a)(3)(ii), which requires a swap dealer to disclose to its counterparties all material incentives and conflicts of interest before a swap transaction; § 23.433, which requires communication with a counterparty in a fair and balanced manner; and § 23.602(a), which requires a swap dealer to diligently supervise its business and implement policies and procedures reasonably designed to prevent the violations of the CEA and CFTC regulations. Notably, the CFTC did not find in either of these two enforcement actions that the swap dealers' failure to disclose caused actual harm to their customers. It follows that to allege the violation of disclosure violations under Part 23 of the CFTC regulations, it is sufficient for the CFTC to merely show a possibility that the disclosures were inadequate, without demonstrating that a swap dealer's customer actually experienced any negative economic consequences.

These enforcement actions follow several previous CFTC matters involving primarily pre-trade marks as well as the March 4, 2019 *Bogucki* decision in U.S. District Court of the Northern District of California. In that case, the court had held that a trader was not involved in "front-running" because the underlying ISDA documentation clearly stated that the counterparties are acting on an arm's-length basis.

It is likely that in response to these recent CFTC enforcement developments, OTC swaps documentation, such as ISDA's General Disclosure Statement or the futures- and options-related industry standard disclosures, will need to be updated to provide a more robust set of hedging and pre-hedging disclosures.

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