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ABA BUSINESS LAW SECTION
DERIVATIVES & FUTURES LAW COMMITTEE
WINTER MEETING
JANUARY 24-26, 2019
LA PLAYA BEACH & GOLF RESORT
NAPLES, FL

Market Structure Deep Dive
January 26, 2019
8:30 a.m. – 9:30 a.m.

Chair:
Michael Philipp (Morgan Lewis)

Panel:
Terry Arbit (Winston)
Anita Herrera (Nodal Exchange)
Bob Klein (Citi)
Peter Malyshev (Reed Smith)
Lisa Shemie (CBOE)
Maggie Sklar (CFTC)
With consensus around the regulatory benefit of reporting OTC derivative contracts, the bulk of the [legislative] debate was devoted to the complicated task of how the clearing mandate would be applied and which types of market participants would need to migrate positions into a cleared environment, but the operational aspects of the execution mandate were left to be finalized near the end of the process and unfortunately received less attention due to a push for quick completion of the legislation – this is probably evident from the verbiage, or lack thereof, that appears in the statute on this matter. . . . [W]hen the [CFTC’s] subsequent Swap Execution Regulations were established, it is not surprising that varying statutory interpretations emerged among Commissioners at that time.1

These comments were made by CFTC Commissioner Dawn Stump, in her Opening Statement at the Open Meeting at which the CFTC proposed a comprehensive set of amendments to its rules governing swap execution facilities (“SEFs”).2

Based on the comments of other Commissioners at that Open Meeting, it appears that the statutory interpretations of the verbiage regarding SEFs in the Dodd-Frank Act3 are no less varied today. For his part, Chairman Giancarlo stated:

Contrary to provisions of Dodd-Frank that permit SEFs to operate by “any means of interstate commerce,” the current SEF rules constrain swaps trading to two methods of execution – request-for-

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1 Opening Statement of Commissioner Dawn D. Stump before the CFTC Open Meeting, November 5, 2018, available at https://www.cftc.gov/PressRoom/SpeechesTestimony/stumpstatement110518. Commissioner Stump noted that her comments were based on the vantage point of her “front row seat during the development of the Dodd-Frank Act” as a legislative staffer at that time. Id.


3 Dodd-Frank Wall Street Reform and Consumer Protection Act, Sections 721 (Definitions) and 733 (Swap Execution Facilities), Public Law 111-203, 124 Stat. 1376 (2010) (the “Dodd-Frank Act”).
quote or order book. . . . I have called for revising our current restrictions on SEF activity and allowing flexible methods of execution for swaps transactions using any means of interstate commerce, exactly as Congress intended.4

Commissioner Berkovitz, by contrast, expressed a very different view of Congressional intent:

This Proposal is a fundamental overhaul of the SEF regulatory regime. The changes create a trading system that is so flexible that all swaps traded on SEFs – including the most liquid – could be traded the same way they were before the Dodd-Frank reforms were adopted. . . . This is not what Congress intended when it passed the Dodd-Frank Act.5

Two of the central elements of the Proposed SEF Rules are proposals to eliminate the mandates: 1) in CFTC Rule 37.3(a)(2) that, as a requirement of registration, a SEF must offer an Order Book;6 and 2) in CFTC Rule 37.9(a)(2) that a SEF transaction that is subject to the trade execution requirement (referred to in the CFTC’s rules as a “Required Transaction”)7 must be executed either by an Order Book, or by a Request for Quote System that operates in conjunction with an Order Book and in which the quote is transmitted to no less than three unaffiliated market participants (“RFQ-to-3”).8 As reflected in the quotations above, Chairman Giancarlo and Commissioner Berkovitz have opposite views as to whether the current rules are consistent with Congressional intent. This paper will explore the evolution of the statutory SEF definition and

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6 17 C.F.R. § 37.3(a)(2). The term “Order Book” is defined in CFTC Rule 37.3(a)(3), 17 C.F.R. § 37.3(a)(3).

7 The trade execution requirement is contained in Section 2(h)(8) of the Commodity Exchange Act (“CEA”), 7 U.S.C. § 2(h)(8). Pursuant to CFTC Rule 37.9(a)(1), 17 C.F.R. § 37.9(a)(1), a SEF transaction that involves a swap that is subject to the trade execution requirement is referred to as a “Required Transaction.”

8 17 C.F.R. § 37.9(a)(2). The mandatory Order Book and RFQ-to-3 execution methods do not apply to block trades. Id. The requirement that a Request for Quote System transmit the quote to no less than three market participants is set forth in CFTC Rule 37.9(a)(3), 17 C.F.R. § 37.9(a)(3).
substantive SEF provisions during the legislative consideration of the Dodd-Frank Act to see whether it sheds any light on what Congress actually intended on this issue.

EVOLUTION OF THE SEF PROVISIONS IN THE DODD-FRANK ACT

The Administration’s Proposal: The seeds of what ultimately became known as SEFs were planted in a letter dated May 13, 2009, that Timothy Geithner, the Secretary of the Treasury Department, sent to Congressional leadership (the “Geithner Letter”) outlining the Administration’s framework for the regulation of over-the-counter (“OTC”) derivatives. With respect to trade execution, the Geithner Letter stated:

Market efficiency and price transparency should be improved in derivatives markets by . . . moving the standardized part of these markets onto regulated exchanges and regulated transparent electronic trade execution systems for OTC derivatives . . . . Furthermore, regulated financial institutions should be encouraged to make greater use of regulated exchange-traded derivatives. Competition between appropriately regulated OTC derivatives markets and regulated exchanges will make both sets of markets more efficient and thereby better serve end-users of derivatives.9

The Geithner Letter, however, did not provide any guidance as to what these electronic trading systems should look like or how they should operate (except that they should be something different from, and compete with, exchanges). Given that the CEA at the time provided for a plethora of platforms other than exchanges (e.g., exempt commercial markets, exempt boards of trade, derivatives transaction execution facilities), the Geithner Letter raised far more questions than it answered.

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The following month, the Treasury Department published its blueprint for financial regulatory reform, entitled “A New Foundation: Rebuilding Financial Supervision and Regulation.” One of the pillars of this New Foundation was comprehensive regulation of all OTC derivatives, including “[r]equiring standardized OTC derivatives to be . . . executed on exchanges and other transparent trading venues.”\textsuperscript{10} The New Foundation, however, did little to flesh out the details of these transparent trading venues, as its description of the Administration’s intentions with respect to the trading of derivatives was taken verbatim from the Geithner Letter.\textsuperscript{11}

The first clue as to the future of swap trading platforms came two months later, when the Treasury Department submitted proposed statutory text to Congress to implement the regulatory reforms regarding OTC derivatives that it had announced in its New Foundation blueprint.\textsuperscript{12} The proposed legislation required registration for what it termed “alternative swap execution facilities,” but it did not define the term “alternative swap execution facility.”

The proposed legislation contained certain “criteria for registration” of SEFs including, with respect to trading procedures, a requirement that a registered SEF “establish and enforce rules or terms and conditions defining, or specifications detailing, trading procedures to be used in entering and executing orders traded on or through its facilities.”\textsuperscript{13} The Treasury Department’s


proposed legislation also contained two other registration criteria (relating to deterrence of abuses and financial integrity of transactions), as well as 12 core principles, none of which related to execution methods.14

**The House of Representatives:** Just four months later, in December 2009, the House of Representatives passed its version of the Dodd-Frank Act. With respect to trading platforms, the House legislation generally mirrored the Administration’s proposed OTC derivatives legislation, but re-named them “swap execution facilities” and made some notable changes.

First, the version of the legislation that was introduced on the House Floor, after consideration by the House Financial Services and Agriculture Committees, included a definition of the term “swap execution facility.” It was contained in the same section of the proposed CEA amendments as the substantive provisions that would govern SEFs, and defined the term “swap execution facility” to mean:

> an entity that facilitates the execution of swaps between two persons through any means of interstate commerce but which is not a designated contract market.15

This version of the legislation also contained the same registration criteria and core principles as the Administration’s proposal, except that it omitted a core principle addressing position limits or accountability.16

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14 *Id.* at 47-52.


16 *Id.* at 547-554.
Second, the legislation that subsequently passed the House moved the definition of a “swap execution facility” to the definitions section of the proposed CEA amendments, and also revised it. The new definition provided that the term “swap execution facility” means:

a person or entity that facilitates the execution or trading of swaps between two persons through any means of interstate commerce, but which is not a designated contract market, including any electronic trade execution or voice brokerage facility.\(^\text{17}\)

Separately, the Dodd-Frank Act as adopted by the House moved the registration criteria that had appeared in previous versions of the legislation into the core principles. It also re-inserted the core principle on position limits or accountability, and added three new core principles (for a total of 15). The registration criterion relating to trading procedures was moved into core principle (4), but the wording was not altered.\(^\text{18}\)

**The Senate:** As the calendar turned to 2010 and the Dodd-Frank Act moved to the Senate, that chamber did not begin with the SEF definition adopted by the House. Rather, the Senate Committee on Banking, Housing, and Urban Affairs, which initially considered the legislation, returned to the “alternative swap execution facility” nomenclature, returned the definition to the substantive section of the proposed CEA amendments governing SEFs, and provided that the term “alternative swap execution facility” means:

an electronic trading system with pre-trade and post-trade transparency in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by other participants that are open to multiple participants in the system, but which is not an exchange.\(^\text{19}\)


\(^{18}\) Id. at 646-655.

This version of the legislation also returned to the registration criteria and 12 core principles that
the Administration originally proposed, including the registration criterion regarding trading
procedures.\textsuperscript{20}

By the time the legislation reached the Senate floor, though, the nomenclature once again
referred to swap execution facilities, the definition had again been moved to the definitions section,
and that definition had been revised yet again. The definition in the legislation that was debated
on the Senate floor provided that the term “swap execution facility” means:

\begin{quote}
\textit{a facility in which multiple participants have the ability to execute
or trade swaps by accepting bids and offers made by other
participants that are open to multiple participants in the facility or
system, through any means of interstate commerce, including any
trading facility, that – (A) facilitates the execution of swaps between
persons; and (B) is not a designated contract market.} \textsuperscript{21}
\end{quote}

This version of the legislation had the same 15 core principles for SEFs that were contained in the
House-passed bill, including core principle (4) with respect to trading procedures.\textsuperscript{22} And that is
how the SEF definition read, and the SEF core principles appeared, when the Senate subsequently
passed them.\textsuperscript{23}

\textbf{Conference Committee:} The final legislation that emerged from the Conference
Committee defined the term “swap execution facility” to mean:

\begin{quote}
\textit{a trading system or platform in which multiple participants have the
ability to execute or trade swaps by accepting bids and offers made
by multiple participants in the facility or system, through any means
of interstate commerce, including any trading facility, that – (A)
\end{quote}

\textsuperscript{20} \textit{Id.} at 591-599.

\textsuperscript{21} S. 3217, Restoring American Financial Stability Act of 2010, at 557 (April 29, 2010), \textit{available at}
https://www.govinfo.gov/content/pkg/BILLS-111s3217as/pdf/BILLS-111s3217as.pdf.

\textsuperscript{22} \textit{Id.} at 670-681.

\textsuperscript{23} H.R. 4173, Restoring American Financial Stability Act of 2010, at 547 (definitions), 662-673 (core principles)
facilitates the execution of swaps between persons; and (B) is not a designated contract market.\textsuperscript{24}

This definition of the term “swap execution facility” that was enacted in the Dodd-Frank Act\textsuperscript{25} was close, but not identical, to the one that had passed the Senate. There were two changes: 1) the Senate bill’s definition of a SEF as a “facility” with certain characteristics became a “trading system or platform” with certain characteristics; and 2) the Senate bill’s requirement that multiple participants “have the ability to . . . accept[] bids and offers made by other participants that are open to multiple participants” was changed to require that multiple participants “have the ability to . . . accept[] bids and offers made by multiple participants.”

Finally, the Dodd-Frank Act as adopted by the Conference Committee contained the 15 core principles for SEFs that were passed by both the House and the Senate.\textsuperscript{26} The wording in core principle (4) addressing trading procedures did not materially change from the time it first appeared as a “registration criterion” in the Administration’s original proposal through its enactment in the Dodd-Frank Act.

CONSIDERATIONS CONCERNING CONGRESSIONAL INTENT

As illustrated by the foregoing recitation, at no point during its development by the Administration or in Congress did the SEF provisions of the Dodd-Frank Act address particular types of execution methods that could, should, or must be utilized by registered SEFs. The CEA’s core principle (4) for SEFs in the CEA simply provides that a SEF “shall establish and enforce rules or terms and conditions defining, or specifications detailing trading procedures to be used in

\textsuperscript{24} H.R. 4173, Dodd-Frank Wall Street Reform and Customer Protection Act, at 295 (July 15, 2010), available at https://www.congress.gov/111/bills/hr4173/BILLS-111hr4173enr.pdf.

\textsuperscript{25} CEA Section 1a(50), 7 U.S.C. § 1a(50).

\textsuperscript{26} See fn. 24, supra, at 338-342; CEA Section 5h(f), 7 U.S.C. § 7b-3(f).
entering and executing orders traded on or through the facilities of the swap execution facility.”27

As is the nature of a core principle, no particular trading procedure or method of entering and executing orders is mentioned – either in terms of a Congressional requirement or a prohibition.

That said, the mandated use of an Order Book as a SEF registration requirement in current CFTC Rule 37.3 is difficult to reconcile with the evolution of the statutory SEF provisions described above. To be sure, early versions of the statutory text included certain SEF “registration criteria,” but the one that addressed trading procedures did not require any particular type(s) of execution methods. Indeed, the text of that provision subsequently was moved into core principle (4), and the statute as enacted does not include any “registration criteria” – or any mandated execution method – at all.

Given the yawning silence of the statute’s substantive SEF provisions with respect to particular execution methods, the CFTC has looked to the statutory SEF definition for guidance. In proposing the current rules governing SEFs, the CFTC stated:

The “multiple participant to multiple participant” requirement, when read in conjunction with the impartial access requirement . . . requires that each SEF provide any market participant with the ability to make any bid or offer transparent to all other market participants of the SEF.28

And in adopting the current SEF rules, the CFTC discussed how it reconciled imposing mandatory execution methods for Required Transactions in Rule 37.9 with the “through any means of interstate commerce” language in the SEF definition of the Dodd-Frank Act.29 This is this same

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interstate commerce language that serves as the foundation for the proposal to eliminate these mandatory execution methods for Required Transactions in the Proposed SEF Rules.\textsuperscript{30}

Yet, the evolution of the SEF definition as the Administration’s original proposed statutory text worked its way through Congress to become the Dodd-Frank Act suggests that neither the CFTC’s current SEF rules, nor the Proposed SEF Rules, may be correctly construing the Congressional intent underlying that definition. In particular, the RFQ-to-3 requirement of current CFTC Rule 37.9 – which inherently means that a request-for-quote cannot be sent to just a single market participant (“RFQ-to-1”) – appears to be inconsistent with the evolution of the statutory definition of the term “swap execution facility.”

As noted above, the Senate bill (the last version of the legislation before it went to the Conference Committee) defined a SEF as a facility in which multiple participants “have the ability to . . . accept[] bids and offers \textit{made by other participants that are open to multiple participants}.” The SEF definition in the legislation that emerged from the Conference Committee and that is now enshrined in law, by contrast, provides that multiple participants need only “have the ability to . . . accept[] bids and offers \textit{made by multiple participants}.”

An RFQ-to-1 system would not have satisfied the SEF definition adopted by the Senate, since it is not “open to multiple participants.” However, it would appear to satisfy the SEF definition as enacted, which omitted this requirement and only requires the ability to accept bids and offers from multiple participants.

\textsuperscript{30} Proposed SEF Rules, 83 Fed. Reg. at 61964 and n. 135 (“[T]he SEF must operate a trading system or platform in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants in the facility or system, through any means of interstate commerce,” citing the SEF definition). \textit{See also} fn. 4, \textit{supra}.
On the other hand, it is not clear that the “any means of interstate commerce” language in the SEF definition was necessarily indicative of a Congressional intent to permit SEFs to employ any and all varieties of trade execution methods for Required Transactions. Such language is employed in several other provisions of the CEA\(^3\) for jurisdictional purposes, in order to assure that the scope of CFTC regulation in a given area does not exceed the bounds of the federal government’s constitutional authority over interstate commerce. To read the interstate commerce language in the SEF definition as a jurisdictional limitation on the reach of the CEA’s regulation of SEFs – rather than a substantive directive regarding permissible methods of trade execution on a SEF – is particularly plausible given that when the legislation first utilized this language (see, e.g., the bill that was introduced on the House floor), it also provided in sweeping terms that a registered SEF “may trade any swap.”\(^3\)

In sum: Confronted with Congressional silence on the issue of execution methods in the CEA’s substantive SEF provisions, the CFTC has in its current rules, and continues in the Proposed SEF Rules, to conflate the definition of the term “swap execution facility” with the execution methods for Required Transactions that may be permitted, or mandated, on a system that meets

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31 See, e.g., CEA Section 3(a), 7 U.S.C. § 5(a) (finding that transactions subject to the CEA “are entered into regularly in interstate and international commerce”); CEA Section 4b(a)(1), 7 U.S.C. § 6b(a)(1) (referring to “any contract of sale of any commodity in interstate commerce”); CEA Section 6(c)(1), 7 U.S.C. § 9(1) (same); CEA Section 4c(a)(1), 7 U.S.C. § 6c(a)(1) (referring to a “transaction in interstate commerce” and a “commodity sold, shipped, or received in interstate commerce”).

32 See fn. 15, supra, at 546. In the version of the legislation that passed the House, this language was re-worded to read that a registered SEF “may make available for trading any swap,” see fn. 17, supra, at 645. This re-worded language also was included in the legislation that passed the Senate (see fn. 23, supra, at 661), and that was enacted into law, CEA Section 5h(b)(1)(A), 7 U.S.C. § 7b-3(b)(1)(A). It also is telling that the Dodd-Frank Act provided that swaps that are not required to be executed through a SEF “may be executed through any other available means of interstate commerce.” CEA Section 5h(d)(2), 7 U.S.C. § 7b-3h(d)(2). If “any means of interstate commerce” in the SEF definition is interpreted as a substantive provision that all trade execution methods are permissible on a SEF, then it is difficult to perceive the need for, or the meaning of, this language with respect to transactions that do not occur on a SEF. It may be the case that in both instances, the language is a recognition of the jurisdictional boundaries on the government’s authority to regulate methods of trade execution for swaps, whether traded on or off of a SEF.
that SEF definition. The foregoing discussion expresses no view as to whether in doing so, any particular interpretation of the SEF definition is right or wrong. Rather, it is meant to point out the difficulty in trying to squeeze the “round peg” of execution methods into the “square hole” of the SEF definition.

That difficulty arises because these are, fundamentally, separate questions. The SEF definition addresses the question: What is a SEF that is required to register with the CFTC? The question at hand, however, is when a SEF exists and is registered: What execution methods can, or must, that SEF provide for the execution of swap transactions? On the latter question, as reflected in the legislative history set out above, the substantive SEF provisions enacted by Congress express no intent.

Yet, Congress granted the CFTC broad authority to issue rules relating to the operations of SEFs, and it cannot be said that Congress gave no indication of its intent with respect to the CFTC’s exercise of that rulemaking authority. It clearly and unambiguously stated that the goal of the CEA provisions governing SEFs enacted by the Dodd-Frank Act, “is to promote the trading of swaps on swap execution facilities and to promote pre-trade price transparency in the swaps market.” And by providing for SEFs through amendments to the CEA, Congress also assured that: 1) the CFTC’s rules governing SEFs would be subject to the stated purpose of the CEA “to

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33 The SEF Proposed Rules recognize this conflation when they note that eliminating the required functionality provisions of the current rules would mean that “the only trading functionality obligation that a SEF must comply with on an ongoing basis is based upon the CEA . . . definition of SEF” and that “the SEF definition in [the] CEA would serve as the baseline requirement for the type of trading systems or platforms that a SEF must maintain.” SEF Proposed Rules, 83 Fed. Reg. at 61964 and n. 134.

34 See CEA Section 5h(f)(1)(A)(ii), 7 U.S.C. § 7b-3(f)(1)(A)(ii) (CFTC may impose requirements on SEFs by rule or regulation pursuant to CEA section 8a(5), 7 U.S.C. § 12a(5)); CEA Section 5h(h), 7 U.S.C. § 7b-3(h) (CFTC shall prescribe rules governing the regulation of SEFs).

35 See, CEA Section 5h(e), 7 U.S.C. § 7b-3(e).
promote responsible innovation and fair competition among boards, of trade, other markets and market participants;”36 and 2) before issuing any such rules, the CFTC would “consider the costs and benefits of the action.”37

These are the indicia of Congressional intent that commenters on the SEF Proposed Rules should address, and that the CFTC should focus on in any final rulemaking. The SEF Proposed Rules, and the separate statements of Chairman Giancarlo and Commissioner Berkovitz commenting on them, all address these considerations, as is appropriate. For a debate over these Congressional dictates – promoting SEF trading, pre-trade price transparency and fair competition, while considering applicable costs and benefits – will be far more useful in fashioning final rules regarding execution methods for Required Transactions on SEFs than will a futile search for evidence of Congressional intent as to what those rules should provide. The legislative history of the statutory SEF provisions discussed above confirms, as Commissioner Stump recalled, that such an expression of Congressional intent simply does not exist.

36 See CEA Section 3(b), 7 U.S.C. § 5(b).
Panel on "Market Structure Deep Dive"
January 24-26, 2019
LaPlaya Beach and Golf Resort
Naples, FL

CFTC Proposes to Expand the
SEF Registration Requirement—Is More Necessary or Better?

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I. Background

Not so long ago, swaps primarily traded on a private individually negotiated basis between counterparties, and such swap transactions were often facilitated by interdealer brokers. Although trading platforms (markets) such as exempt commercial markets, exempt boards of trade, and excluded electronic trading facilities were authorized under the Commodity Exchange Act ("CEA" or the "Act") pursuant to the Commodity Futures Modernization Act of 2000, and Commodity Futures Trading Commission ("CFTC" or the "Commission") regulations promulgated thereunder, their use by market participants was optional, and such trading facilities were subject to only very light regulation and oversight. Under CFTC regulations in effect prior to the adoption of the Dodd-Frank Act, there was no requirement that any swaps be traded on a regulated trading facility. That changed with the adoption of the Dodd-Frank Act in 2010, which amended the CEA, and the promulgation of the CFTC’s SEF rules in 2013, to provide a new and comprehensive regulatory framework governing the trading of swaps, including the registration and regulation of swap execution facilities ("SEFs") and the imposition of a trade execution requirement on SEFs for certain categories of swaps subject to SEF made available to trade ("MAT") determinations.1

After several years of experience with the trading of swaps under the new SEF regulatory framework, the Commission is proposing a major revamp of the rules governing SEFs. The Commission appears to be concerned primarily by the limited amount of swap trading and liquidity formation taking place on SEFs. On November 5, 2018 the Commission held a public meeting to discuss, and then, on November 30, 2018, the CFTC published for comment, proposed amendments to the SEF rules in Part 37 of its regulations. The SEF Proposal, among other things, attempts to clarify what activity constitutes SEF activity and requires a party conducting such activity to register with the CFTC as a SEF.2 The proposed amendments would significantly expand the type and number of entities that would be required to register as SEFs. In particular, "interdealer brokers" for swaps and "aggregators of single-dealer swap platforms" would need to register as SEFs, including interdealer brokers that are currently registered with the CFTC as introducing brokers ("IBs")3 and their personnel that facilitate the trading of swaps away from SEFs. Additionally, in the SEF Proposal, the CFTC proposes to revise the swap trade execution requirement by doing away with the current SEF voluntary MAT determination process and instead providing that all swaps that are subject to the Commission’s mandatory clearing requirement must be traded on a SEF, exempt SEF, or DCM (if listed for trading on a SEF or DCM). Taken together, these changes are intended to ensure that more liquidity formation and swap trading takes place on SEFs.4

II. Expanded SEF Registration under the SEF Proposal

Section 1a(50) of the CEA defines "swap execution facility" to mean "a trading system or platform in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants in the facility or system, through any means of interstate commerce, including any trading facility," that—(A) facilitates the execution of swaps between persons; and (B) is not a designated

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1 Currently, swaps that are subject to the CEA Section 2(h)(1) mandatory clearing requirement (primarily "on the run" index CDS and fixed to floating interest rate swaps in benchmark tenors) must be executed on a registered SEF unless no SEF makes it available to trade. The MAT process provides for a SEF to file a determination with the CFTC that a particular type or category of swap should be listed for (mandatory) SEF trading, which could include swaps that are subject to the mandatory clearing requirement, or swaps that are not subject to such requirement. Currently, not all of the swaps that are subject to the mandatory clearing requirement have been subject to a MAT filing, and thus may be traded off-SEF or voluntarily on a SEF (similar to those categories of swaps that are not subject to the mandatory clearing requirement).


3 The term "introducing broker" means a person who is engaged in soliciting orders for the purchase or sale of a commodity interest (including swaps and futures contracts) and does not accept any money or property to margin or secure such trades or contracts. Section 1a(31) of the CEA; 7 U.S.C. § 1a(31).

4 SEF Proposal at 61952.

5 Under the Commodity Exchange Act, the term "trading facility" means "a person or group of persons that constitutes, maintains, or provides a physical or electronic facility or system in which multiple participants have the ability to execute or trade agreements,
contract market.” Essentially, a platform or system that facilitates “many-to-many” trading of swaps is a SEF.

In the SEF Proposal, the CFTC explains that its policy goal is to apply more consistent regulatory treatment to very similar swaps market activity currently taking place on SEFs and through interdealer brokers or single-dealer aggregators that are not currently registered as SEFs. The overarching theme of the SEF Proposal as to when registration is required is when multiple participants have the ability to trade with multiple other participants within the facility. The SEF Proposal states: “As long as multiple participants have the ability to accept bids and offers from other multiple participants within the facility, the facility or system will meet the SEF definition, regardless of how the multiple participants choose to interact with one another.”

A. Single-Dealer Platforms and Aggregator Platforms

In its prior SEF rulemaking, the CFTC clarified that a Single-Dealer Platform is a one-to-many platform and is not subject to SEF registration. The CFTC described that a SEF Aggregator Platform provides users with the ability to access multiple SEFs, with execution occurring on one of the SEFs and not on the Aggregator Platform. In the prior SEF rulemaking, the CFTC explained that a SEF Aggregator Platform is not a SEF because the Commission views this type of platform as “only providing a portal through which its users may access multiple SEFs and swaps are not executed or traded through the service.”

By contrast, in the SEF Proposal, the CFTC describes a Single-Dealer Aggregator Platform as one that enables multiple dealer participants to provide executable bids and offers to multiple non-dealer participants on the platform and, pursuant to the SEF Proposal, would be required to register as a SEF. Non-dealer participants can “view, execute, or trade swaps posted to the Single-Dealer Aggregator Platform’s system
or platform from multiple dealer participants.”

Distinct from a **SEF Aggregator Portal**, which provides a portal through which users may access multiple SEFs but does not provide a venue for the trading or execution of swaps, a Single-Dealer Aggregator Platform is more than a mere portal. Rather, a Single-Dealer Aggregator Platform provides a system or platform for multiple-to-multiple participant swaps trading or execution and, therefore, is a SEF.

In the SEF Proposal, the Commission again expresses its position that a single-dealer platform would not be required to register as a SEF. The CFTC describes a single-dealer platform as a system or platform “in which a single dealer serves as a single liquidity provider by exclusively providing all bids and offers against which its customers, *i.e.*, participants, trade or execute swaps.” The dealer is the counterparty to all swaps executed on its trading system or platform, and therefore is not a facility for many-to-many trading.

### B. RFQ-to-One Clarification

The SEF Proposal addresses the question whether an RFQ-to-one system meets the multiple participant element of the SEF definition. The CFTC notes that its view in the past suggested that “an 'RFQ-to-one' trading system or platform may, on its face, not meet the SEF definition.” However, the CFTC clarifies that when an RFQ-to-one facility can be used to issue “concurrent or serial RFQs to multiple, different recipients”, this functionality would fit within the SEF definition because “it provides participants the ‘ability’ to accept bids and offers from multiple participants within the trading system or platform.”

According to the SEF Proposal, the definition of SEF does not require that multiple participants interact with multiple other participants simultaneously, but instead the SEF definition requires that multiple participants have the “ability” to execute or trade swaps by accepting bids and offers made by multiple participants. The CFTC views the SEF definition’s use of the term “ability” as capturing concurrent and serial RFQ systems within the SEF definition and SEF registration requirement, now causing these systems to be within the “many-to-many” rubric.

### C. Interdealer Brokers

The SEF Proposal also discusses other types of platforms that would now be subject to SEF registration. Swaps broking entities, including interdealer brokers, that operate a platform or trading system would be required to register as SEFs “because they allow multiple participants to *trade* swaps by accepting bids and offers made by multiple participants in that facility or system.” A platform that facilitates the negotiation or arrangement of swaps, even those instruments not subject to the trade execution requirement, through the interaction of bids and offers is engaged in trading activity that should occur within a SEF, according to the SEF Proposal.

The CFTC notes that although its discussion focuses on the dealer-to-dealer market,
“any person operating a system or platform for multiple-to-multiple participant swaps trading as described herein must register as a SEF”\textsuperscript{21}

The Commission discusses brokers that pre-arrange or pre-negotiate swaps and execute the swaps on a SEF pursuant to the 15-second time delay requirement, stating that “the time delay requirement has enabled interdealer brokers to facilitate ‘trading’ of swaps, \textit{i.e.}, the negotiating or arranging of swaps transactions outside the SEF, through the interdealer brokers’ multiple-to-multiple trading systems or platforms.”\textsuperscript{22} After pre-negotiating or pre-arranging a swap through the interdealer broker’s platform, the broker routes the swap to a SEF, where one side of the transaction is exposed for 15 seconds on the order book prior to entry of the other side of the swap for execution.\textsuperscript{23} An interdealer broker may also perform this type of activity for permitted transactions and, “coupled with the ability to submit Required Transactions in accordance with the time delay requirement, these arrangements essentially enable the operation of multiple-to-multiple trading systems or platforms for a broad range of swaps outside of the SEF regulatory framework.”\textsuperscript{24}

Some swap broking entities are not affiliated with a SEF but similarly negotiate or arrange swaps away from a registered SEF and subsequently submit the swaps to a registered SEF for execution; however, these entities are less common, according to the Commission.\textsuperscript{25} Where the broker and SEF are affiliated, the CFTC suggests that the swaps broking entity could comply with the SEF registration requirement by integrating its non-SEF trading platform and its personnel into its affiliated SEF.\textsuperscript{26}

D. Pre-Execution Negotiation

When "more than one market participant has the ability to trade any swap with more than one other market participant on the system or platform", the person offering the system or platform must register as a SEF (or seek an exemption).\textsuperscript{27} If negotiation occurs directly between participants, the CFTC believes that this activity should occur on a SEF if it involves many-to-many negotiation.\textsuperscript{28} The CFTC’s rationale to require that counterparties negotiate swaps on a SEF is to prevent registered SEFs from being relegated to “de facto” post-trade processing venues.\textsuperscript{29} The CFTC’s view is that allowing pre-execution communications away from a SEF undermines a SEF’s “meaningful role” in “facilitating trading activity and liquidity formation.”\textsuperscript{30}

\textsuperscript{21} Id. at 61959, n. 89.
\textsuperscript{22} Id. at 61958.
\textsuperscript{23} Id.
\textsuperscript{24} Id. at 61958-59.
\textsuperscript{25} Id. at 61958-59, n. 88.
\textsuperscript{26} Id. at 61960.
\textsuperscript{27} Id. at 61960.
\textsuperscript{28} Id. at 61959, n. 91.
\textsuperscript{29} Id. at 61987.
\textsuperscript{30} Id. at 61986. In connection with the Commission’s position that negotiation between participants must occur on a SEF, the Commission has proposed to prohibit pre-trade communications away from the SEF with respect to swaps subject to the trade execution requirement, with limited exception for certain package transactions. See, \textit{e.g.}, Proposed Rule 37.201(b), SEF Proposal at 62097.
III. Interdealer Broker Implications

A. Interdealer Broker

The Commission states that: ""Interdealer broker,’ as used in the SEF Proposal, refers to an interdealer broker entity or operation in the aggregate and not to a particular individual, i.e., an associated person, who works as a broker within the entity or operation."31 Although the Commission specifically defines and discusses interdealer brokers, the Commission clarifies that the SEF Proposal applies to swaps broking entities and more broadly to any person operating a many-to-many swaps trading platform.32 The Commission notes that “many interdealer brokers” are registered as IBs and often are affiliated with a SEF where they submit the swap transactions that they have arranged, but it goes on to state that any interdealer broker that falls within the SEF definition would need to register as a SEF or modify its operations (for example, by integrating its operations and personnel with an affiliated SEF).33

B. “Trading”

The CFTC describes what constitutes swaps “trading” such that a person must register as a SEF. The CFTC states that “trading” means the “negotiating or arranging of swaps between multiple market participants consistent with the SEF registration requirement”.34 The CFTC also states that negotiating or arranging swaps consists of “facilitating the interaction of bids and offers”, and thus constitutes trading.35

C. Examples of IB Activity That Does Not Require SEF Registration

The CFTC provides examples of IB activity that does not require SEF registration. For instance, an interdealer broker that solely solicits or accepts individual or single bids or offers and transmits them to an exchange would not be facilitating swaps trading such that it is required to register as a SEF.36 The CFTC states: “an interdealer broker that solely solicits or accepts individual or single bids or offers and introduces them to an exchange, such as a SEF, would not be required to register as a SEF because it would not be facilitating the ‘trading,’ i.e., negotiating or arranging of swaps between multiple market participants consistent with the SEF registration requirement. Such brokers would be able to continue to engage in such solicitation or acceptance in conformance with the IB definition.”37

In addition, an IB that provides a SEF Aggregator Portal is viewed as merely providing a portal through which its users may access multiple SEFs, rather than providing a venue for the trading or execution of swaps.38 The IB would not be viewed as providing a trading system or platform where multiple participants have the ability to execute or trade swaps with multiple participants within its facility because the multiple-to-multiple participant execution or trading occurs on the SEF and not the SEF Aggregator Portal.39

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31 Id. at 61957, n. 78.
32 Id. at 61959, n. 89.
33 Id. at 61960.
34 SEF Proposal at 61959, n. 94.
35 Id. at 61958.
36 Id. at 61959, n. 94.
37 Id.
38 Id. at 61957.
39 Id.
D. Examples of IB Activity That Requires SEF Registration

Other interdealer broker activities would require SEF registration. Interdealer brokers that operate a trading system or platform that facilitates swap trading primarily between swap dealers would "trigger the SEF registration requirement because they allow multiple participants to trade swaps with multiple participants in a manner consistent with the language of CEA sections 5h(a)(1) and 1a(50)."

The SEF Proposal would apply SEF registration requirements to "swaps broking entities, including interdealer brokers, that are currently registered with the Commission as IBs, and their personnel currently facilitating swaps trading away from SEFs." Also, SEF registration would be required if an IB provides a system or platform that "enables multiple dealer participants to provide executable bids and offers, often via two-way quotes, to multiple non-dealer participants on the system or platform." "Those non-dealer participants are thus able to view, execute, or trade swaps posted to the Single-Dealer Aggregator Platform’s system or platform from multiple dealer participants."

In these scenarios, SEF registration would be required regardless of whether the swaps traded on the facilities are required transactions or permitted transactions. The CFTC clarifies that "the trade execution requirement is not a determinant of whether an entity must register as a SEF by codifying the requirement that an entity must register as a SEF if it permits trading or execution of any swap, including swaps that are not subject to the trade execution requirement, in a manner consistent with the statutory SEF definition, i.e., trading or execution on a ‘multiple-to-multiple’ basis among market participants."

IV. Proposed Amendments to Trade Execution Requirement

The CFTC has proposed to amend the trade execution requirement, which would modify the MAT process under existing rules and instead require a swap to be executed on a SEF, exempt SEF or designated contract market ("DCM") only if the swap is (1) subject to the clearing requirement under Section 2(h)(1) of the CEA; and (2) listed for trading on a SEF or DCM. The SEF Proposal’s trade execution requirement would not apply to swaps subject to the end-user clearing exception under Section 2(h)(7) of the CEA unless such swaps took place voluntarily on a platform with SEF functionality. The SEF Proposal does not address how current MAT swaps will be treated if the SEF Proposal becomes effective without modification, i.e., will current MAT swaps that are not subject to the clearing requirement continue to be subject to the trade execution requirement?

40. Id. The SEF Proposal states: “[T]he Commission believes that it is necessary to apply the SEF registration requirement to ensure that the multiple-to-multiple ‘trading’ that occurs on such trading systems or platforms is subject to the Act and Commission’s regulations as regulated SEFs.” Id.

41. Id. at 61952.

42. Id. at 61956.

43. Id.

44. Id. at 61956. The CFTC explains that a “Single-Dealer Aggregator Platform comports with the SEF definition in CEA section 1a(50) by providing a trading system or platform where multiple dealers send or stream bids and offers to multiple participants, thereby subjecting them to SEF registration.” Id. at 61957. In addition, when an RFQ-to-one facility can be used to issue “concurrent or serial RFQs to multiple, different recipients”, this functionality would fit within the SEF definition because “it provides participants the ‘ability’ to accept bids and offers from multiple participants within the trading system or platform.” Id. at 61965, n. 136.

45. Proposed Rule 36.1. The CFTC has proposed to exclude swaps that are exclusively listed by an exempt SEF from being subject to the trade execution requirement and, therefore, “only a CFTC-registered DCM or SEF would be able to trigger the CEA section 2(h)(8) trade execution requirement by listing a clearing requirement swap.” SEF Proposal at 61979, n. 273.

46. See, e.g., SEF Proposal at 61979.
V. Comment Period and Transition Period

The Commission has provided market participants with a 75-day comment period, and comments are due on or before February 13, 2019.\(^{47}\) Notwithstanding the prescribed comment period, Commissioner Behnam suggested that more time will be needed for market participants to comment on the SEF Proposal.\(^{48}\) Once the Commission adopts final rule amendments, the amendments likely would become effective 90 days from the publication of the final rule in the Federal Register.\(^{49}\)

The Commission proposes to allow a delay period for introducing brokers and foreign firms that must register as SEFs under the SEF Proposal. With regard to swap broking entities, including interdealer brokers registered with the CFTC as introducing brokers, the Commission would provide a six-month transition period during which time the swap broking entities could maintain their current practice of facilitating the negotiation or arrangement of swaps between multiple market participants and routing those swaps to a SEF for execution, so long as the swap broking entities fulfill the following conditions:

(i) All swap transactions that are traded on a swaps broking entity, including an interdealer broker, must be routed for execution to a SEF; and

(ii) The swaps broking entity, including an interdealer broker, must provide electronically the following information with respect to itself to the Secretary of the Commission at submissions@cftc.gov and the Commission’s Division of Market Oversight (“Division” or “DMO”) at DMOSubmissions@cftc.gov: (i) entity name as it appears in the entity’s charter; (ii) name and address of the entity’s ultimate parent company; (iii) any names under which the entity does business; (iv) address of principal executive office; (v) a contact person’s name, address, phone number, and email address; (vi) asset classes and swap products for which the entity facilitates trading; and (vii) any registrations, authorizations, or licenses held.\(^{50}\)

In addition, the Commission would allow a two-year delay and transition period for foreign firms that are captured by the SEF registration requirement. During the two-year transition period, foreign firms could seek an exemption from SEF registration or apply for registration. To rely on this transition period, a foreign firm must submit a notice to DMO and route swaps to a registered or exempt SEF. Specifically, the CFTC would require a foreign firm wishing to rely on the delay to be subject to conditions similar to those of a U.S. firm.\(^{51}\)

The CFTC also states that a swaps broking entity could seek an exemption from SEF registration pursuant to Section 5h(g) of the CEA; however, the CFTC does not provide detail as to the criteria or process for such an exemptive process. Similarly, a foreign firm could seek an exemption from SEF registration pursuant

\(^{47}\) SEF Proposal at 61946.

\(^{48}\) Id. at 62143.

\(^{49}\) SEF Proposal at 61960, n. 100.

\(^{50}\) SEF Proposal at 61963.

\(^{51}\) The conditions a foreign firm must satisfy to rely on the transition period relief include:

(i) All swap transactions involving U.S. persons that are traded on an Eligible Foreign Swaps Broking Entity must be routed for execution to a SEF or an Exempt SEF; and

(ii) The Eligible Foreign Swaps Broking Entities must provide the following information electronically to the Secretary of the Commission at submissions@cftc.gov and DMO at DMOSubmissions@cftc.gov: (i) entity name as it appears in the entity’s charter; (ii) name and address of the entity’s ultimate parent company; (iii) any names under which the entity does business; (iv) address of principal executive office; (v) a contact person’s name, address, phone number, and email address; (vi) asset classes and swap products for which the entity facilitates trading; (vii) certification that the entity currently arranges or negotiates swap transactions for U.S. persons; (viii) the entity’s home country regulator or regulators; and (ix) any registrations, authorizations, or licenses held by the entity in its home country.
to Section 5h(g) of the CEA. The Commission explains that during the two-year transition period, the Commission "could formalize a regulatory framework for providing exemptions from the SEF registration requirement for foreign multilateral swaps trading facilities, including foreign swaps broking entities". The CFTC does not provide detail as to the criteria or process for such an exemptive process.

The transition period relief should facilitate the registration or corporate reorganizations of swaps broking entities that currently route swaps to SEFs or are affiliated with a registered SEF. However, brokers that are not affiliated with a SEF or that engage in swaps that are not listed on any SEF may find it difficult, if not impossible, to rely on the relief. Without relief for these types of brokers, they will need to come into compliance with the SEF rulemaking as of the effective date. Although CFTC Regulation 37.3(b) (as it currently exists and as it is proposed) requires the Commission to review an application for SEF registration within 180 days, Commission review in practice does not happen within this timeframe. The registration process takes much longer than six months. Without a transition period for brokers that do not currently route swaps to a SEF, especially in connection with swaps not listed by any SEF, brokers may not be able to continue to operate by virtue of the SEF Proposal’s expanded definition of SEF and unavailability of practical relief on which they may rely. The Commission should afford such brokers with relief during the pendency of their SEF applications.

VI. Conclusion and Questions

The declared goal of the proposed expanded registration requirement is to “promote more SEF trading and pre-trade price transparency in the swaps market”. The SEF Proposal would significantly expand the scope of the current SEF registration regime. Although the CFTC previously suggested that an RFQ-to-one trading system or platform may not meet the SEF definition, the SEF Proposal has clarified that when an RFQ-to-one facility can be used to issue “concurrent or serial RFQs to multiple, different recipients”, this functionality would fit within the SEF definition because “it provides participants the ‘ability’ to accept bids and offers from multiple participants within the trading system or platform.” The CFTC also explains that a single-dealer aggregator platform enables non-dealer participants to “view, execute, or trade swaps posted to the Single-Dealer Aggregator Platform’s system or platform from multiple dealer participants”, providing a platform for multiple-to-multiple participant swaps trading or execution.

In addition, Registered IBs would need to register as SEFs under the SEF Proposal if “they allow multiple participants to trade swaps by accepting bids and offers made by multiple participants in that facility or system”, and the CFTC notes that despite its focus on the dealer-to-dealer market, “any person operating a system or platform for multiple-to-multiple participant swaps trading as described herein must register as a SEF”.

The Commission estimates that out of the 300 registered IBs designated as a swap firm that brokers swap products approximately 40-60 swaps broking entities (10-20 of which are located outside the U.S.) would need to register as a SEF or join a SEF, but the Commission acknowledges that some of these swap broking entities may cease operating trading systems or platforms that facilitate many-to-many swaps trading.

52 Id. at 61962.
53 SEF Proposal at 61946; see also id. at 61950.
54 Id. at 61965, n. 136.
55 Id. at 61956.
56 Id. at 61959.
57 Id. at n. 89.
58 Id. at 62053-54.
The Commission requested comment on all aspects of the SEF Proposal, including 106 specific questions. But, we believe there are some additional questions that the Commission should consider in evaluating the SEF Proposal:

- Does the SEF Proposal demonstrate how requiring even more entities to register as SEFs (in addition to the current 25 SEFs), and thus further fragmenting market liquidity, actually promotes the stated goal of increased market liquidity?

- Does the SEF Proposal identify any concerns or requests from swap market participants regarding an insufficiency of liquidity on SEFs or the current operations of swap brokers that would justify the expansion of the SEF registration requirement to swap brokers?

- Does the SEF Proposal’s proposed treatment of the brokering of swaps by swap brokers by requiring IBs to register as SEFs result in inconsistent regulatory treatment for the same activities conducted by IBs with respect to economically similar futures contracts?

- Does the SEF Proposal adequately explain why the current registration status of swap brokers as IBs and their personnel as associated persons is insufficient from a regulatory oversight perspective, or why SEF status provides better regulatory oversight of such broker activities?

- Does the SEF Proposal consider other more effective or less burdensome ways to enhance swap market liquidity, such as promoting the ability of more buy-side participants to act as liquidity providers on SEFs through an expanded floor trader exemption, or by promoting open (“all to all”) access to SEFs, or restricting post-trade name give up?

59 The SEF Proposal seems to ignore that the same pre-execution negotiation activity that seems to concern the Commission with respect to IB swap activity takes place by IBs with respect to futures contracts subject to the rules of DCMs (futures exchanges). The SEF Proposal attempts to distinguish swaps from futures, characterizing swaps as having varying liquidity profiles, more concentrated numbers of market participants, and less standardization than futures. SEF Proposal at 61951. This may be a bit of an oversimplification. There are many swaps, particularly those that are subject to the mandatory clearing requirement (and thus would be subject to the trade execution requirement) that are as standardized (and as liquid) as futures contracts. And, there are many futures contracts that have as little liquidity, or only episodic liquidity, and as few market participants, as some swaps products. Yet, futures market participants rely on IBs to arrange liquidity (through various exchange-approved pre-execution negotiation mechanisms) in futures contracts (either for illiquid contracts or large trades) without denigrating the meaningful role of futures exchanges in facilitating trading activity and liquidity formation. See, e.g., “Updated Report, Agricultural Block Trade Analysis”, a report by staff of the Market Intelligence Branch of the Division of Market Oversight, CFTC, October 2018. It is not clear why the same could not continue to be true with swap broker activity without requiring the registration of swaps brokers as SEFs.

60 See, e.g., id. at 62149. Under the SEF Proposal, SEF trading specialists would not be required to be registered with the CFTC, meaning that currently registered associated persons of IBs that must integrate with or become a registered SEF will no longer need to be registered as associated persons or subject to direct CFTC oversight. In his dissent, Commissioner Berkovitz identified flaws with this approach, including that these employees would no longer be subject to supervision under Regulation 166.3.
Action by the CFTC: Swap Execution Facility Registration and Trade Execution

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Le-el D. Sinai

Summary:

On November 5, 2018, the Commodity Futures Trading Commission (CFTC) has taken action in an attempt to provide further clarity to and foster efficiency and liquidity in the swaps market by issuing a proposal to amend rules concerning swap execution facilities (SEFs) and trade execution. In this article we highlight the key takeaways from the notice of proposed rulemaking, along with an analysis of the cross-border implications.

I. Current State of the SEF rules

Under the Commodity Exchange ACT (CEA) Section 2(h)(8), swaps that are subject to the clearing requirement must “(i) execute the transaction on a board of trade designated as a contract market under section 7 of this title; or (ii) execute the transaction on a [SEF]...or a [SEF] that is exempt from registration....” As the rules currently stand, these requirements do not apply if no board of trade or SEF makes the swap available to trade or for swap transactions subject to the clearing exception under CEA Section 2(h)(7).

The CEA currently defines a SEF as a “trading system or platform in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants in the facility or system, through any means of interstate commerce, including any trading facility, that (a) facilitates the execution of swaps between persons; and (b) is not a designated contract market.” Under Section 5(h) of the CEA, all SEFs must register as such with the CFTC, subject to any exemptions. Further detail on and comparison of the current SEF rules and the proposed rules are included below.

II. Proposed Rule: Amendments to Regulations on SEFs and the Trade Execution Requirement

The proposed rule is an outgrowth from CFTC Chairman Giancarlo’s White Paper on SEFs published in 2015 (the 2015 White Paper). In addition to adopting many of the concepts from the 2015 White Paper, the proposed rule also codifies many of the CFTC No Action Letters and interpretations since 2013. As of this writing, the proposed rule has been published in the Federal Register and the comment period is running.

a. SEF Registration Requirement

The proposed rule would require certain swaps broking entities such as interdealer brokers and aggregators of single-dealer platforms to comply with the SEF registration requirements. The proposal includes a six-month delay from the SEF registration requirement for U.S. swaps broking entities and a two-year delay for foreign swaps broking entities. The proposal would also codify the “footnote 88 issue” by requiring entities that meet the SEF definition to register as a SEF. The question of whether the swaps that they list for trading are subject to the trade execution requirement would no longer be a determining factor. It is estimated that there will be about 40-60 additional registrants as a result of the proposed rule, however most of those additional entities would be affiliated with SEFs that are currently already registered and would likely be absorbed by the registered SEF.

b. Trade Execution and Methods of Execution

The CEA requires SEFs to provide for execution through certain means only once the SEF as declared the trade as “made available to trade” (MAT). Included within the proposed rules is an elimination of the MAT determination process for SEFs and designated contract markets. Instead, trade execution requirements would apply to swaps that are both subject to the clearing requirement and listed by a SEF or designated contract markets for trading. The trade execution requirement would be subject to the following exemptions: (i) swaps subject to a clearing exception or exemption; (ii) swap components of package transactions involving the issuance of a new bond; (iii) swaps between inter-affiliates; and (iv) swaps listed for trading only by an exempt SEF.

The proposed rules would eliminate the requirement of a SEF to offer an Order Book for all of the swaps that it lists for trading. The proposed rule defines an Order Book as:

(i) an “electronic trading facility,” as that term is defined in CEA section 1a(16); (ii) a “trading facility,” as that term is defined in CEA section 1a(51); or (iii) a trading system or platform in which all market participants have the ability to enter multiple bids and offers, observe or receive bids and offers entered by other market participants, and transact on such bids and offers.

Additionally, a SEF would no longer be limited to offering an Order Book or Request for Quote system requiring transmission of requests to a minimum of three market participants. The

6 An “Order Book” is defined by the CFTC as “[a] market structure, electronic or through other means of communication, whereby bids and offers are matched exclusively based on their price and/or the time that they arrived at the market.” https://www.cftc.gov/ConsumerProtection/EducationCenter/CFTCGlossary/index.htm.
7 A “Request for Quote” is defined by the CFTC as “[a] trading system or platform whereby market participants transmit a request for buy or sell prices for a specific instrument and transaction size to other market participants, similar to a competitive bidding process.” https://www.cftc.gov/ConsumerProtection/EducationCenter/CFTCGlossary/index.htm.
proposed rule would eliminate the exceptions to the prohibition on pre-arranged trading and prohibit pre-execution communications conducted away from a SEF except with respect to swaps that are either not subject to the trade execution requirement or a portion of a transaction that is not subject to the trade execution requirement.

c. SEF Trading Specialists

The proposal would require SEFs to employ “SEF trading specialists,” who would facilitate swaps trading and execution for SEFs. The proposed rule defines SEF trading specialist as “any natural person who, acting as an employee (or in a similar capacity) of a swap execution facility, facilitates the trading or execution of swaps transactions (other than in a ministerial or clerical capacity), or who is responsible for direct supervision of such persons.” A SEF would be required to adopt (i) fitness qualifications that prohibit certain persons from acting as a SEF trading specialists consistent with the CEA’s statutory disqualifications, (ii) proficiency testing, (iii) ethics training, and (iv) a code of conduct.

The proposed rules would also establish a SEF duty of supervision over SEF trading specialists. As the rules currently stand, SEF employees who serve as interdealer brokers or otherwise facilitate trading in connection with SEF trades are not subject to the requirements listed above. The proposal does not seek to preclude brokers from serving as such outside of the SEF.

d. Impartial Access Requirements

Included in the proposed rule is a provision that permits a SEF to establish its own requirements for access to its “markets, market services, and execution methods, including any indicative quote screens or any similar pricing data displays.” According to the proposal, the criteria for access must be transparent, fair, and non-discriminatory and applied to all or “similarly situated” market participants in a “fair and non-discriminatory” manner. Accordingly, the criteria should be non-arbitrary and based on objective, pre-established requirements or limitations.

In addition, the proposed rule requires SEFs to “establish and impartially enforce rules governing any decision to deny, suspend, permanently bar, or otherwise limit market participants’ access to the swap execution facility, including when such decisions are made as part of a disciplinary or emergency action taken by the swap execution facility.” The SEF, however, must “maintain documentation of any decision to deny, suspend, permanently bar, or otherwise limit access of a market participant to the swap execution facility.”

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8 17 CFR 37.201(c)(1).
10 17 CFR 37.202(b).
e. **Straight-Through Processing Requirements**

Separately under the proposed rules, SEFs and derivatives clearing organizations (DCOs) must work jointly to facilitate processing and routing of trades to DCOs in a “prompt, efficient, and accurate manner.” Additionally, the “as quickly as technologically practicable” standard within the proposed rules requires a DCO to accept or reject swap or futures transactions within a specified time frame. Furthermore, the proposed rules codify existing staff guidance that requires SEFs to facilitate pre-execution credit screening for swaps intended to be cleared. They also require market participants to identify a clearing futures commission merchant before each order.\(^\text{11}\)

f. **Financial Resources Requirements**

Included within the proposal is an amendment to the financial resources requirements which clarifies that a SEF is only required to maintain adequate financial resources to cover the operating costs needed to comply with the SEF core principles and CFTC regulations for a one-year period. Also amended under the proposal is the existing liquid resource requirement form six months of a SEF’s operating costs to the greater of (i) three months of a SEF’s projected operating costs; or (ii) the projected costs for a SEF to wind down its business, as determined by the SEF. The proposal sets for new Acceptable Practices for the purposes of determining a SEF’s projected operating costs. The Acceptable Practices are based on staff guidance, which identifies select operating costs that SEFs may exclude or pro-rate when projecting their operating cost calculations.\(^\text{12}\)

g. **SEF Compliance and Self-Regulatory Organization Oversight**

The proposed rules would permit SEFs to consider their trading operations and market in designing and implementing their enforcement programs, disciplinary procedures, and sanctions. SEFs could also choose additional types of entities to serve as regulatory service providers in order to help fulfill their compliance requirements. The proposed rules would simplify the chief compliance officer’s existing duties and submission of a SEF’s annual compliance report, and provide a SEF’s CEO or equivalent officer with the same oversight responsibilities over the chief compliance officer as the SEF’s board.\(^\text{13}\)

h. **Interdealer Brokers**

The proposed rules also set out registration requirements for interdealer brokers.\(^\text{14}\) Interdealer brokers, as detailed in the proposed rules, “refers to an interdealer broker entity or

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\(^{12}\) 17 CFR 37.1301-37.1307.

\(^{13}\) 17 CFR 37.204(b).

\(^{14}\) Interdealer broker trading systems or platforms facilitate swaps trading between multiple customers by negotiating or arranging swaps through voice-based or voice-assisted systems that combine voice functionalities with electronic systems such as order books. 17 CFR 37 at 61958.
operation in the aggregate and not to a particular individual, i.e., an associated person, who works as a broker within the entity or operation.”\textsuperscript{15}

The preamble to the proposed rules notes that the SEF rules, as currently constructed, have led to certain swaps activities to be conducted away from registered SEFs in pre-Dodd-Frank Act\textsuperscript{16} form. Notably, while some interdealer brokers are affiliated with SEFs, there is a divided system currently in place whereby an interdealer broker may negotiate or arrange a swap away from a SEF and on an affiliated broking platform. This allows the interdealer broker to conduct itself in a manner that avoids the burdens imposed by SEF registration requirements. Accordingly, the proposed rules set out to bridge this gap by applying SEF registration requirements and the definition of a SEF (CEA sections 5h(a)(1) and 1a(50), respectively) to certain broking entities, including interdealer brokers.

The proposal also sets out to apply the SEF registration requirements to single-dealer aggregator platforms, which operates a trading system or platform that aggregates multiple Single-Dealer Platforms and, thus, enables multiple dealer participants to provide executable bids and offers, often via two-way quotes, to multiple non-dealer participants on the system or platform. Those non-dealer participants are thus able to view, execute, or trade swaps posted to the Single-Dealer Aggregator Platform’s system or platform from multiple dealer participants. These types of systems or platforms, however, have not registered their operations as SEFs.\textsuperscript{17}

The CFTC believes that such entities should be subject to the SEF registration requirements because they meet the SEF definition in CEA section 1a(50) by “allowing multiple participants to trade swaps by accepting bids and offers made by multiple participants in the facility or system.”\textsuperscript{18}

i. Footnote 195

Under the existing rules\textsuperscript{19} there is a requirement that SEFs obtain and incorporate documentation into an issued confirmation. However this requirement placed an unnecessarily high financial, administrative, and logistical burdens. Accordingly, the proposed rules eliminate this requirement on a time-limited basis. Under the proposal, SEFs may incorporate applicable relationship terms from previous agreements by reference in the confirmation without obtaining copies of the agreements prior to execution.\textsuperscript{20}

\textsuperscript{15} 17 CFR 37 at 61957.
\textsuperscript{17} 17 CFR 37 at 61956.
\textsuperscript{18} Id.
\textsuperscript{19} 17 CFR 37.6(b).
\textsuperscript{20} 17 CFR 37 at 61972-61973.
j. Cross-border Implications

The CFTC laid the groundwork for extraterritorial application of its SEF registration requirement in its guidance, published by the Division of Market Oversight (DMO Guidance),\(^{21}\) in 2013. According to the DMO Guidance,

multilateral swaps trading platform located outside the United States that provides U.S. persons or persons located in the U.S. (including personnel and agents of non-U.S. persons located in the United States) (“U.S.-located persons”), with the ability to trade or execute swaps on or pursuant to the rules of the platform, either directly or indirectly through an intermediary, will register as a SEF or DCM.\(^{22}\)

The DMO Guidance went on to state that several factors would be relevant in evaluating whether the SEF registration requirement would apply to a multilateral swaps trading platform located outside the U.S.:

(1) Whether a multilateral swaps trading platform directly solicits or markets its services to U.S. persons or U.S.-located persons; or (2) whether a significant portion of the market participants that a multilateral swaps trading platform permits to effect transactions are U.S. persons or U.S.-located persons.\(^{23}\)

By requiring certain U.S. and non-U.S. interdealer brokers to register as SEFs (or seek exemption from registration), the proposed rules seek to bring clarity to the DMO Guidance. In furtherance thereof, the proposed rules state in the preamble that certain non-domestic operations, including foreign swaps broking entities such as foreign interdealer brokers, would need time to register or seek exemption from registration. Given the complexity involved in such issues, the CFTC proposed to delay the compliance date of the requirement with respect to such entities. The delay would also allow the CFTC to further develop its cross-border regulatory regime, including establishment of additional comparability determinations with foreign regulatory frameworks.\(^{24}\) All of this is to say that the jury is still out with respect to cross-border implications for foreign interdealer brokers, however preparations for SEF registration or seeking out exemption from registration must be made.

Section 5h(g) of the CEA permits the CFTC to grant exemption from the SEF registration requirements if it finds that a foreign SEF is subject to comparable, comprehensive supervision.


\(^{22}\) Id. The CFTC believed that U.S. persons and U.S.-located were persons whose activities have the requisite “direct and significant” connection with activities in, or effect on, commerce of the U.S. within the meaning of CEA section 2(i).

\(^{23}\) Id.

\(^{24}\) 17 CFR 37 at 61958.
and regulation in its home country. In December 2017, pursuant to section 5h(g), the CFTC announced the issuance of an order exempting certain multilateral trading facilities (MTFs) and organized trading facilities (OTFs) authorized within the European Union (EU) from the requirement to register with the CFTC as SEFs. According to the order, EU legal requirements establish regulatory frameworks that satisfy the CEA standard for granting an exemption from the SEF registration requirement.

Under the proposed rules, the CFTC has proposed a two year delay in the compliance date for any final rule on SEF registration that applies to foreign entities that, based on their activity, would need to register as SEFs. This delay would provide those foreign entities with an opportunity to assess their options regarding registration or seeking out of exemption with their local regulator. Moreover, the CFTC cites the need for such time to further develop its cross-border regulatory regime and the extent of its reach in asserting its jurisdiction.

III. Conclusion

The CFTC took several important steps toward fulfilling Chairman Giancarlo’s Project KISS on November 5, 2018. Proposing to amend rules concerning SEFs attempts to streamline regulatory requirements and eliminate those that reduce competition and liquidity. These efforts will be part of a continuous effort to provide regulatory clarity to U.S. and non-U.S. entities in the swaps market.

25 Including the Markets in Financial Instruments Regulation, the Markets in Financial Instruments Directive and the Market Abuse Regulation.
26 17 CFR 37 at 62052.