

CLIENT ALERT

Swaps Markets in Transition: Understanding the CFTC's Proposed Rule on SEFs

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On November 30, 2018, the Commodity Futures Trading Commission (“**CFTC**”) proposed extensive amendments to the rules applicable to trading swaps on a swap execution facility (“**SEF**”).¹ If adopted, the SEF Proposal would transform the manner in which market participants transact on SEFs and the regulatory requirements applicable to SEFs. According to the CFTC, the SEF Proposal is designed to tailor the regulatory requirements for SEF trading to the swap markets. Comments are due on February 13, 2019.

As described in the SEF Proposal, when the CFTC first adopted its regulatory framework for SEFs in 2013, it relied too heavily upon its experience regulating the futures markets where contracts are standardized.² The standardization of futures contracts allowed futures trading to occur via bids and offers executed on a structured order book (or through limited exceptions). With this experience in mind, in the 2013 SEF Rule, the CFTC transplanted the concept of order book trading onto the market for swaps traded on a SEF. However, through its implementation efforts, the CFTC has found that because swaps are more customized relative to futures, the use of an order book to trade swaps on a SEF is not suitable in all instances. In an attempt to increase trading activity on SEFs, the SEF Proposal moves away from the futures model of an order book, and toward a more flexible approach that provides SEFs with significantly more discretion regarding the methods of execution for swaps traded on their respective platforms.

¹ See *Swap Execution Facilities and Trade Execution Requirements*, 83 Fed. Reg. 61946 (Nov. 30, 2018) (“**SEF Proposal**”).

² See also *Core Principles and Other Requirements for Swap Execution Facilities*, 78 Fed. Reg. 33476 (Jun. 4, 2013) (“**2013 SEF Rule**”).

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Below is an in-depth summary of the key elements of the SEF Proposal as well as the separate CFTC request for comment regarding the practice of post-trade name give-up for swaps executed on a SEF.

I. Enhanced Flexibility for SEFs to Offer Different Execution Methods

One of the hallmarks of the SEF Proposal is to provide greater flexibility for SEFs to offer differing execution methods. At present, all SEFs must offer order book functionality to register as a SEF. In addition, if a swap is required to be executed on a designated contract market (“DCM”) or SEF (a “**Required Transaction**”), a market participant must execute the swap via an order book or a request for quote disseminated to at least three unaffiliated market participants (“**RFQ-3**”). The CFTC originally adopted the futures trading concept of an order book for SEFs with the stated goal of promoting pre-trade price transparency.

The SEF Proposal would significantly alter the existing framework to tailor SEF rules to the customized nature of the swaps markets. Key modifications to the current framework would include:

- *Eliminating the SEF Minimum Functionality Requirement.* SEFs would no longer be required to provide an order book to register (or remain registered) as a SEF.
- *Eliminating the Order Book and RFQ-3 for Required Transactions.* Market participants would no longer be required to execute a Required Transaction through an order book or an RFQ-3. Rather, a SEF could provide for execution through “any means of interstate commerce.”
- *Disclosure of Execution Methods.* Pursuant to Core Principle 2, a SEF would be required to disclose in its rulebook all available trade execution methods. To the extent a SEF has discretion when facilitating trading, the SEF would have to disclose in its rulebook the manner in which the SEF exercises discretion for each execution method. Finally, a SEF would have to disclose in its rulebook the sources and methodology used for generating any market pricing information the SEF provides to facilitate trading and execution.

II. Expansion of the Mandatory Trading Requirement

The Commodity Exchange Act (“**CEA**”) requires that swaps subject to mandatory clearing be executed on a DCM or SEF (“**Mandatory Trading Requirement**”).³ However, the CEA provides that the Mandatory Trading Requirement does not apply if “no [DCM or SEF] makes the swap available to trade.”⁴ Under the SEF Proposal, the CFTC would consider a swap to be made available to trade, and thus subject to the Mandatory Trading Requirement, if the swap is listed on any DCM or SEF.

³ See CEA Section 2(h)(8)(A).

⁴ See CEA Section 2(h)(8)(B). At times, the CFTC abbreviates the phrase “made available to trade” as “**MAT**.”

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As discussed below, this change would significantly expand the number of swaps subject to the Mandatory Trading Requirement. The practical impact is that most (if not all) swaps subject to mandatory clearing would also be subject to the Mandatory Trading Requirement. If finalized, the near-term impact is that the interest rate and credit default swaps that are currently subject to mandatory clearing, but not yet subject to the Mandatory Trading Requirement, would likely be subject to the Mandatory Trading Requirement.

A. Elimination of MAT Determinations

At present, the CFTC's rules establish a fairly complicated process to determine that a swap is "made available to trade" ("**MAT Determination**"). First, a DCM or SEF submits a filing to the CFTC demonstrating that a swap meets certain liquidity criteria, and thus, is made available to trade.⁵ If the filing is approved, the swap is subject to the Mandatory Trading Requirement pursuant to a compliance schedule. Because of the MAT Determination process, at present, only a portion of the swaps subject to mandatory clearing are also subject to the Mandatory Trading Requirement.

The CFTC established the MAT Determination process because its current rules limit the methods of execution for swaps subject to the Mandatory Trading Requirement to an order book or RFQ-3. The MAT Determination process helps to ensure that swaps subject to mandatory clearing may, in fact, be executed on an order book or through an RFQ-3 before the Mandatory Trading Requirement applies.

As explained above, the SEF Proposal would eliminate the requirement that swaps subject to the Mandatory Trading Requirement be executed on an order book or through an RFQ-3. Rather, the SEF Proposal would allow SEFs to provide for execution methods through any means of interstate commerce. Given the proposed flexibility for SEFs to offer various execution methods, the MAT Determination process would no longer be necessary. Instead, the CFTC would re-interpret the phrase "made available to trade" in Section 2(h)(8)(B) of the CEA to mean that a DCM or SEF "lists" the swap to trade.⁶ Therefore, if a swap is subject to mandatory clearing, and a DCM or SEF lists the swap on its platform, the swap automatically would be subject to the Mandatory Trading Requirement.

Because trading liquidity is one of the factors the CFTC considers when making a mandatory clearing determination, the practical impact of the CFTC's new interpretation of the phrase "made available to trade" means that most (if not all) swaps subject to mandatory clearing would also be subject to the Mandatory Trading Requirement.

⁵ See CFTC Rule 37.10.

⁶ The SEF Proposal codifies the CFTC's interpretation in Part 36 of the CFTC's Rules.

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B. Exceptions to the Mandatory Trading Requirement

The SEF Proposal codifies existing exceptions and establishes new exceptions to the Mandatory Trading Requirement as follows:

- *Elections to Utilize a Clearing Exception.* The SEF Proposal would establish an exception for any market participant electing to rely on an exception to mandatory clearing specified in CEA Section 2(h) or the CFTC's Part 50 Rules. Examples include the end-user clearing exception, cooperative clearing exception and the inter-affiliate clearing exception. This proposed exception to the Mandatory Trading Requirement does not appear to alter the CFTC's current regime, but rather codifies existing exceptions.
- *Swaps Eligible for the Inter-Affiliate Clearing Exception that the Parties Elect to Clear.* To the extent affiliates are eligible to rely upon the inter-affiliate exception to mandatory clearing, but nevertheless elect to clear the swap, the SEF Proposal establishes an exception to the Mandatory Trading Requirement. This would codify existing time-limited CFTC Staff no-action relief.⁷
- *Swaps that are Part of a Package Transaction in Connection with a New Bond Issuance.* Swaps that are executed as components of a new bond issuance are eligible for an exception to the Mandatory Trading Requirement. These "package" transactions involve at least one swap component that is subject to the Mandatory Trading Requirement and at least one component that is a bond issued and sold in the primary market. To qualify as a "package" transaction, the SEF Proposal requires that: (i) the execution of each component transaction be contingent upon the execution of all other component transactions; and (ii) the component transactions be priced or quoted together as one economic transaction with simultaneous or near simultaneous execution of all components. This proposed exception would codify existing time-limited CFTC Staff no-action relief.⁸
- *Swaps Listed Only on an Exempt SEF.* The SEF Proposal would establish an exception to the Mandatory Trading Requirement for swaps that are only listed on a SEF that is exempt from registration pursuant to CEA Section 5h(g). This proposed exception is not provided under existing CFTC Rules or CFTC Staff no-action relief.

⁷ See CFTC Letter No. 17-67 (Dec. 14, 2017).

⁸ See CFTC Letter No. 17-55 (Oct. 31, 2017).

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C. Compliance Schedule for Swaps Subject to the Mandatory Trading Requirement

The SEF Proposal would establish a transitional compliance schedule for any swaps that would become subject to the Mandatory Trading Requirement under the SEF Proposal. As described below, the compliance schedule would commence upon the effective date of any final rule.

Counterparty	Category 1	Category 2	All Other Entities
Category 1	90 days	180 days	270 days
Category 2	180 days	180 days	270 days
All Other Entities	270 days	270 days	270 days

Category 1 entities include swap dealers.⁹ Category 2 entities include commodity pools, private funds as defined in Section 202(a) of the Investment Advisers Act of 1940, and persons predominantly engaged in activities that are in the business of banking, or that are financial in nature as defined in Section 4(k) of the Bank Holding Company Act of 1956.

D. Registry of Swaps Subject to the Mandatory Trading Requirement

To ensure that market participants have notice of the swaps that are subject to the Mandatory Trading Requirement and the venues listing those swaps, the SEF Proposal would establish a registry under CFTC Rule 36.2(a).

To enable the CFTC to publish and maintain such a registry, the CFTC proposes a new Form TER, which SEFs and DCMs would be required to file periodically identifying those swaps listed on their platform that are subject to mandatory clearing. SEFs and DCMs also would be required to file this form within 10 business days of the effective date of any final rule, as well as upon any new product filing.

III. Expansion of Entities Required to Register as a SEF

The SEF Proposal would expand the scope of entities that are required to register as a SEF including to single-dealer aggregator platforms, and to certain swaps broking entities, such as interdealer brokers that operate “trading systems or platforms” for the facilitation of multiple-to-multiple swaps trading. Most of these entities currently are registered with the CFTC as introducing brokers. The CFTC argues that these proposed amendments would increase price discovery and concentrate liquidity formation on SEFs.

⁹ This category also includes major swap participants, security-based swap dealers, and security-based major swap participants, although at present, there are no registrants in these categories.

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Section 5h(a)(1) of the CEA requires that no person may operate a facility for the trading and processing of swaps unless it is registered as a SEF or a DCM. Under the CFTC's current rules, this registration requirement only applies to facilities meeting the definition of SEF under the CEA. Section 1a(50) of the CEA defines "swap execution facility" 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." In the 2013 SEF Rule, the CFTC provided interpretive guidance addressing the applicability of the definition to certain types of entities, and generally determined that "aggregation services or portals" ("**SEF Aggregator Portals**") and "one-to-many systems or platforms" ("**Single Dealer Platforms**") do not meet the statutory SEF definition.

Under the SEF Proposal, the CFTC identifies what it describes as a "different type of a trading system or platform" that it believes implicates the SEF registration requirement. The CFTC describes this category as including "trading systems or platforms that aggregate Single Dealer Platforms," otherwise referred to as Single-Dealer Aggregator Platforms. As described, these platforms enable multiple dealer participants to provide executable bids and offers to multiple non-dealer participants. The CFTC also proposes to apply the registration requirement to swap broking entities, such as interdealer brokers that allow multiple participants to trade swaps with multiple participants by negotiating or arranging swaps through voice-based or voice-assisted systems that combine voice functionalities with electronic systems. Finally, the SEF Proposal would codify language from the preamble of the 2013 CFTC Rule providing that any person operating a facility meeting the statutory SEF definition must register regardless of whether the swaps that it lists for trading are subject to the Mandatory Trading Requirement.¹⁰

The registration requirement in the SEF Proposal would be phased in, with domestic entities required to register within six months and foreign entities required to register within two years of the compliance date set forth in any final rule. This delay is intended to provide adequate time for the CFTC to address pending cross-border issues, including establishing a framework for an entity to become an exempt SEF pursuant to CEA Section 2(h). The phased-in compliance dates also are subject to the condition that any swaps arranged by these entities must be routed through a SEF for execution. The CFTC estimates that there may be one single-dealer aggregator and between 40 to 60 swap broking entities that would need to register under any final rule in order to continue operations unless qualifying for an exemption.

¹⁰ See Proposed CFTC Rule 37.3(a)(1). See also *Core Principles and Other Requirements for Swap Execution Facilities*, 78 Fed. Reg. 33476, 33481 n.88 (Jun. 4, 2013).

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IV. Limitations on Pre-Arranged Trading and Pre-Execution Communications

Although the SEF Proposal would expand the methods of execution that a SEF may provide for swaps subject to the Mandatory Trading Requirement, it would require that SEFs prohibit participants from engaging in certain pre-arranged trading and pre-execution communications, including negotiating or arranging the terms and conditions of a swap prior to execution on the SEF.¹¹ Specifically, it would eliminate the exception for block trades and certain other transactions. The CFTC argues that this change would aid in price discovery and foster liquidity on SEFs by ensuring that the entire swaps trading process, including pre-trade and post-trade protocols, occurs on a SEF in most cases.

The SEF Proposal would, however, provide an exception to the prohibition on pre-execution communications away from the SEF for swaps not subject to the Mandatory Trading Requirement. In addition, the CFTC also would provide an exception for “package transactions” that involve component swaps subject to the Mandatory Trading Requirement along with components that are not subject to the Mandatory Trading Requirement. To qualify as a package transaction, the component transactions must be: (i) contingent upon one another; (ii) priced or quoted together as one economic transaction; and (iii) executed simultaneous or near simultaneous to each other.

V. New Requirements for SEF Trading Specialists

The SEF Proposal includes new requirements for certain employees and agents of SEFs, referred to in the SEF Proposal as “SEF trading specialists.”¹² These include minimum fitness qualifications and proficiency testing, mandatory ethics training and supervision requirements. The CFTC justifies these new proposed requirements based on its view that SEF trading specialists serve an intermediary role by facilitating the trading or execution of swaps for market participants.

VI. Impartial Access Amendments

The SEF Proposal would amend the current requirement that SEFs must provide impartial access to their platforms.¹³ Under the SEF Proposal, a SEF could limit market access in a variety of ways, including, for example, based on the type of market participant. However, the SEF Proposal would require SEFs to implement objective, non-arbitrary and pre-established participation criteria. Moreover, the criteria must be transparent, fair, and non-discriminatory as applied to all *or similarly situated market participants*. There are pros and cons to this approach. On one hand, the CFTC argues that allowing SEFs to design their platform to cater to certain market participants will result in an overall increase in swap market liquidity. However, others have expressed concerns that imposing any barriers to access, by definition, creates an

¹¹ See Proposed CFTC Rule 37.201(b).

¹² See Proposed CFTC Rule 37.201(c).

¹³ See Proposed CFTC Rule 37.202; and CFTC Letter No. 17-17 (Mar. 24, 2017).

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uneven playing field, allowing SEFs to offer markets that feature levels of liquidity and competitive pricing that only a limited category of participants may access.

VII. Proposed Amendments Related to SEF Compliance Requirements

The SEF Proposal would amend the compliance requirements that apply to SEFs in an effort to better tailor the regulatory regime to the swaps market. Key proposed amendments include:

- Replacing the requirement that a SEF issue a confirmation at the same time as execution with a requirement for the SEF to issue a confirmation “as soon as technologically practicable”;¹⁴
- Codifying existing no-action relief to limit the confirmation requirement for uncleared swaps to a “trade evidence” record to codify that a SEF is not required to retain swap trading relationship documentation for uncleared swaps;¹⁵
- Providing additional discretion for SEFs to tailor their rule enforcement programs and automated trade surveillance systems, and eliminating specific requirements such as those currently requiring the computation of gains, losses, and swap equivalent positions;¹⁶
- Eliminating the real-time market monitoring requirement specified in Core Principle 2 because it is redundant with the requirement specified in Core Principle 4;¹⁷
- Clarifying certain aspects of the straight-through processing requirements, including for error trades and pre-execution credit checks;¹⁸
- Amending the minimum financial resource requirements so that a SEF’s financial resources must cover one year of operating costs that a SEF needs to “comply” with the SEF Core Principles as opposed to the current requirement that a SEF’s financial resources must cover one year of operating costs that a SEF needs in order to continue all of its existing activities;¹⁹ and
- Simplifying the Chief Compliance Officer (“**CCO**”) requirements, including among other things, eliminating the requirement that the CCO meet with or provide information to a regulatory oversight committee (“**ROC**”),

¹⁴ See Proposed CFTC Rule 37.6.

¹⁵ See Proposed CFTC Rule 37.6(b) and CFTC Letter No. 17-17 (Mar. 24, 2017).

¹⁶ See Proposed CFTC Rule 37.203.

¹⁷ See Proposed CFTC Rule 37.203; and 37.400.

¹⁸ See Proposed CFTC Rule 37.203.

¹⁹ See Proposed CFTC Rule 37.1301.

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amending restrictions on removing a CCO, providing a non-exclusive list of criteria that would be required in hiring a CCO, limiting the CCO's duty to addressing only "material" conflicts of interest, and streamlining the annual compliance report.

VIII. Request for Comment: Post-Trade Name Give-Up

Separate and apart from the SEF Proposal, the CFTC published a request for comment ("**Request for Comment**") surrounding the post-trade name give-up requirements for transactions executed on a SEF.²⁰ Importantly, the Request for Comment is not a proposed rule, so in order to adopt a final rule, the CFTC would first need to publish a proposed rule for public comment.

The term "post-trade name give-up" refers to the practice of disclosing the identity of each swap counterparty to the other after a trade has been matched anonymously. According to the Request for Comment, the practice originated as a necessary practice for uncleared swaps to enable a market participant to perform a credit check on its counterparty prior to finalizing a trade, and to keep track of credit exposure and payment obligations for individual counterparties. Although important for uncleared swaps, the need for post-trade name give-up in the cleared swap markets "is less clear cut" because a central counterparty eliminates individual credit risk and counterparty exposure.²¹ In addition, swaps intended to be cleared are subject to pre-execution credit checks and straight-through processing requirements.

The Request for Comment describes some of the comments the CFTC has received regarding the practice of post-trade name give-up in the cleared swaps market. For example, certain buy-side participants believe the practice limits liquidity, is anti-competitive, and unnecessary for credit purposes. In the alternative, some commenters believe that the practice allows liquidity providers to more precisely allocate liquidity.

Comments to the Request for Comment are due by January 29, 2019.²²

²⁰ See *Post Trade Name Give-Up on Swap Execution Facilities*, 83 Fed. Reg. 61571 (Nov. 30, 2018).

²¹ Request for comment at 61571.

²² As noted above, comments to the SEF Proposal are due by February 13, 2019.

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If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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