Swap Execution Facilities Launch in 2013, but Many Issues Remain for 2014

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A cornerstone of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("*Dodd-Frank*")[1] is the requirement that swap counterparties transact standardized swaps on regulated multilateral platforms.[2] Historically, swaps and other OTC derivatives in most asset classes were largely negotiated and executed privately between the parties away from any exchange or similar trading facility. According to the Commodity Futures Trading Commission ("*CFTC*"), the privately negotiated swaps market "provided little, if any, pre- or post-trade transparency."[3] As to the minority of swaps that did trade on multilateral platforms, these platforms were not generally subject to comprehensive, swaps-specific regulation. The swap trade execution requirement is one of the key requirements of the G-20 commitments[4] and was intended partially to "provide pre- and post-trade transparency for end users, market participants, and regulators."[5]

As the first step to implementing the swap trade execution requirement, many platforms were required to register with the CFTC under a new category—a swap execution facility ("*SEF*") as of October 2, 2013. On that date, any facility or platform "in which more than one market participant has the ability to execute or trade swaps with more than one other market participant" was required to be registered or temporarily registered as a SEF under the CFTC's final rule regarding SEFs (the "*SEF Rule*")[6] in order to continue operating lawfully. This registration requirement applies to any electronic or voice-execution venue by which participants can execute swaps, including options (other than those operated by individual liquidity providers such as single-dealer platforms).

Many multilateral trading platforms therefore began operating as SEFs on October 2, 2013.[7] However, many issues regarding SEF execution and operation remain unresolved. Although the CFTC addressed some of these problems by issuing a series of no-action letters and interpretations prior to the October 2 deadline and others subsequently, these staff letters left many questions unanswered and, in some instances, created new complications. Prompt resolution of these issues was delayed for several weeks by the Federal government shutdown that occurred the day before the SEF compliance date, leaving the CFTC with virtually no staff to assist with the interpretation and implementation of the SEF Rule.

We note that the futures trading model on designated contract markets ("*DCMs*"), or exchanges, is a bottom-up business model that evolved naturally over two centuries and was codified in the 1920s[8]. Unlike the futures trading model, the trading model for SEFs is a top-to-bottom model and was created legislatively and by CFTC rule, and was implemented in a matter of four months in the summer and the fall of 2013. Accordingly, SEFs are only at the beginning of a very long road. SEFs, market participants and the CFTC inevitably will have to remain flexible and adjust the SEF model in light of experience and business practices that may continue to evolve.

This article analyzes the fundamentals of the SEF Rule, the major initial issues that have arisen during implementation of the SEF Rule and the CFTC's attempts thus far to resolve these problems. We then review issues that still persist and preview what to expect in 2014.

I. THE SEF RULE

A. Definition of "Facility"

In response to numerous requests for clarification regarding the scope of the SEF registration requirement, the CFTC stated in the SEF Rule that "any person operating a facility that offers a trading system or platform in which one or more market participant has the ability to execute or trade swaps with more than one other market participant on the system or platform shall register the facility as a swap execution facility . . . or as a designated contract market."[9] The CFTC added in a footnote that a facility would be required to register as a SEF if it operates in a manner that meets the SEF definition even though the facility only executes or trades swaps that are not subject to the CFTC's mandatory trade execution requirements.[10] In practice, this means that any platform that facilitates the execution of swaps through a multiple-to-multiple trading mechanism must register as a SEF and comply with the core principles set forth in the SEF Rule.

This broad registration requirement surprised many market participants. In reliance on the proposed rule, these market participants believed that because Permitted Transactions are not required to be executed on a SEF or DCM, a trading system or platform that only facilitates such swaps would not be required to register as a SEF. However, footnote 88 makes clear that the SEF registration requirement is not tied to the trade execution requirement. Rather, any trading platform that facilitates the execution of *any* swaps on a multiple-to-multiple basis must register as a SEF, even if the swaps are exclusively Permitted Transactions.[11] This late realization was troublesome for these participations due to the lead time necessary to develop a platform that complies with the SEF Rule, especially the "minimum trading functionality" requirement (see below) that order book execution always be offered (even for Permitted Transactions), and then apply for and obtain temporary SEF registration prior to October 2, 2013.

Single-dealer platforms, on the other hand, are not required to register as SEFs because they facilitate the execution of swaps through a "one-to-many" process, whereby market participants may only transact with a single liquidity provider.[12] However, market participants may only execute Permitted Transactions—and not Required Transactions—on single-dealer platforms because such platforms are not registered as SEFs.[13] Other types of entities that the CFTC determined would not, in most circumstances, be required to register as a SEF include: (i) aggregation or service portals providing users with the ability to access multiple SEFs but that do not provide for execution on their aggregation services,[14] (ii) service providers facilitating portfolio compression transactions[15] and (iii) swap processing services.[16] Although service providers facilitating portfolio compression generally do not have to register, those that offer risk management exercises may have to register because new transactions are executed through the exercises on those platforms.

While not addressed by the SEF Rule, the CFTC has recently questioned whether prime brokers using an agency model ("***PBs***") would need to register as SEFs. In a typical agency prime brokerage arrangement (used extensively for foreign exchange swaps), a PB authorizes a market participant (a "***Counterparty***") to negotiate swaps with certain specific executing dealers ("***EDs***"). When a Counterparty and ED agree on the terms of a swap, they bring those terms to the PB for execution. As long as the terms are within the parameters authorized by the PB (including the credit line extended by the PB to the Counterparty), the PB enters into one swap with the Counterparty and an equal and opposite swap with the ED. Thus, the Counterparty and ED get the benefit of the negotiated swap, but never actually enter into a transaction with each other. As a result, the Counterparty does not need a bilateral arrangement or credit line from the ED because the PB is the actual counterparty to the trade. CFTC staff initially expressed concern, however, that PBs are effectively facilitating the execution of swaps (even though they act as a principal with both the Counterparty and ED), and therefore would have to register as a SEF. After a series of meetings and calls with industry representatives and counsel, CFTC staff appears to have a deeper understanding of the FX prime brokerage model and be open to reviewing its initial reaction.

Due to the extensive regulation applicable to SEF trading, and the requirement that SEF participants submit to a SEF's jurisdiction in order to use the SEF, many market participants have initially sought alternative execution methods. It remains to be seen whether a significant volume of liquidity will move to single-dealer platforms or purely bilateral methods of execution. Such alternative methods of execution are only viable for Permitted Transactions. While as of this writing all swaps are Permitted Transactions, this universe will decrease over time as swaps in various asset classes become subject to the clearing and trading mandate (*i.e.*, become Required Transactions), since Required Transactions generally must be executed on a SEF (or DCM). As discussed below, four classes of interest rate swaps and two classes of credit default swaps are currently subject to the clearing mandate. Several SEFs have filed "made available to trade" certifications with the CFTC with respect to swaps within these classes, and the outgoing CFTC Chairman Gensler had publicly stated the expectation that at least some of these certifications would become effective in mid-January 2014, with the first Required Transactions being executed in mid-February 2014.

B. Minimum Functionality and Execution Methods

An entity that is required to register as a SEF must ensure that its operations comply with a minimum trading functionality requirement. Although not mandated by the Dodd-Frank Act, the CFTC interprets this requirement to mean that all SEFs must offer an "order book," defined generally as an electronic trading facility, a trading facility, or 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, and transact on such bids and offers.[17]

In the proposed rule, the CFTC would have required all Required Transactions to be executed on an order book or a request for quote ("***RFQ***") system involving no fewer than five market participants.[18] The SEF Rule reduced this "RFQ-to-five" requirement so that market participants need only send an RFQ to two other participants, which will increase to three after one year.[19] While the debate at the CFTC was apparently very focused on the minimum number of RFQ recipients, some market participants have indicated that the difference between two, three or even five is relatively small. This is because any requirement to send an RFQ to multiple liquidity providers (instead of one) creates a potential "winner's curse" for the liquidity provider whose quote is accepted by the RFQ requester, since other market participants polled in the RFQ are aware of the proposed swap and may attempt to front-run in the market the RFQ winner's foreseeable hedging or layoff trades.

For Permitted Transactions, a SEF may offer any method of execution, including voice-based systems.[20] However, the SEF Rule requires all SEFs to have an order book, even if such SEFs only offer Permitted Transactions.[21] Moreover, the SEF Rule states that a SEF "must offer an Order Book for Permitted Transactions" and that market participants must be able to "utilize the Order Book . . . for Permitted Transactions."[22] As a result, SEFs must build an order book that may be used to trade any swaps that are listed on the SEF (even if no participants ever choose to trade on the order book).[23] As noted above, many SEFs were caught off-guard by this requirement and had to quickly implement significant technological changes.

C. Made Available to Trade Determinations

As discussed above, all Required Transactions must be executed on or pursuant to the rules of a SEF or DCM. A Required Transaction is a swap that is: (i) subject to the clearing requirement, (ii) determined to have been "made available to trade" by a SEF or DCM and (iii) not exempt from the clearing and/or trading requirements by virtue of the end-user exception.[24] Permitted Transactions (*i.e.*, swaps that are not Required Transactions) may be executed on a SEF or DCM, but may also be executed in any lawful manner, such as bilaterally or OTC.

In May, 2013, the CFTC issued a final rule (the "***MAT Rule***") that empowers SEFs and DCMs to determine whether a swap is "made available to trade" (and thus a Required Transaction). The MAT Rule states that a SEF or DCM shall consider, as appropriate, one or more of the following factors when making that determination, and may do so for a single swap or group of similar swaps:

- Whether there are ready and willing buyers and sellers;
- The frequency or size of transactions;
- The trading volume;
- The number and types of market participants;
- The bid/ask spread; or
- The usual number of resting firm or indicative bids and offers.[25]

These factors are facially similar to those considered in supporting the clearing mandate for a particular swap or class of swaps. Arguably a somewhat higher standard should apply in the case of the SEF trading mandate—for example, sufficient liquidity and standardization are relevant to valuing swaps for clearing margin and risk management, but a higher minimum level may be needed to support sustained mandatory execution on a SEF or DCM. If, after considering these factors, a SEF or DCM determines that a given swap should be made available to trade, the SEF or DCM must submit its determination to the CFTC, either for approval or self-certification, pursuant to the rule filing procedures of part 40 of the CFTC's regulations.[26]

Currently, four classes of interest rate swaps and two classes of index credit default swaps are subject to the clearing mandate. Three SEFs and one DCM have filed made available to trade determinations for certain interest rate swaps, and three SEFs have made these filings with regard to certain index credit default swaps within these classes.[27] These SEFs have all used the self-certification method, pursuant to which the CFTC has, and has used, rights to stay effectiveness of the certifications and to request public comment. At the end of this period, the certification may become effective and thirty days thereafter such swaps become Required Transactions. Outgoing CFTC Chairman Gary Gensler has publicly stated that he expects these determinations to take effect by mid-February, 2014,[28] which would trigger the mandatory trading requirement for the relevant interest rate swaps and index credit default swaps.

Under the MAT Rule, once a "made available to trade" determination is effective as to one SEF or DCM, other SEFs or DCMs that list the same swap or swaps may rely on the first SEF or DCM's determination without making an independent one.[29] Determinations need not be periodically reviewed or renewed by a SEF or DCM and are valid until no SEF or DCM any longer lists the relevant swap or swaps.[30] Given this context and consequences, some public commenters to the initial self-certifications have urged the CFTC to apply the stated criteria rigorously and to consider a phased or orderly migration of "Permitted Transactions" to "Required Transactions."

D. Time Delay Requirement for Required Transactions

Consistent with the proposed rule, the SEF Rule imposes a "15-second rule" on traders who have the ability to execute against a customer's order or execute two customers' orders against each other. This rule requires such traders to disclose their customers' trades to the market for 15 seconds executing against such order.[31] The stated purpose of this requirement is to ensure a minimum level of pre-trade transparency for Required Transactions by allowing other market participants to participate in a trade where a broker engages in some form of pre-arrangement or pre-negotiation.[32]

The SEF Rule clarifies that the 15-second time-delay requirement only applies to a SEF's order book.[33] Moreover, the SEF Rule acknowledges that the time-delay requirement should take into account a product's characteristics and, therefore, allows SEFs to adjust the time period of the delay based upon liquidity or other product-specific considerations.[34]

E. Core Principles

Consistent with the CEA's statutory requirements, the SEF Rule establishes rules implementing and expanding upon the 15 core principles listed in the CEA. SEFs are required to comply with these Core Principles initially and on a continual basis in order to register and operate as a SEF.[35] The rules implementing the SEF Core Principles are similar to those set forth in the proposed rule, but there are certain modifications and clarifications. For example, in the SEF Rule, the CFTC clarified that with respect to Core Principle 2 pertaining to "access requirements," all members of SEF and all market participants accessing the SEF through a member must submit to the SEF's jurisdiction.[36] In response to public comments, the final Core Principles are less prescriptive than proposed, permit SEFs greater flexibility in applying them and in some provisions were recast as guidance. For example, the CFTC modified the core principle requirements to provide SEFs flexibility in creating "disciplinary panels" rather than requiring a specific "Review Panel" and "Hearing Panel" for assessing potential violations of SEF rules. [37]

II. SELECTED IMPLEMENTATION AND ONGOING ISSUES

SEFs and market participants encountered numerous issues during the SEF application process and onboarding process, causing some participants to claim that they simply would not trade on SEFs until these issues were resolved. Other issues emerged after the October 2, 2013 registration deadline. Some of these issues are discussed below.

A. Application Process and Temporary Registration

The timeframe for the SEF application process was relatively short, considering that many would-be SEFs had to transform from almost entirely unregulated platforms to fully functioning self-regulatory organizations. The CFTC allowed only 120 days between the publication of the SEF Rule and the compliance date. During that time, SEFs were required to prepare and submit their applications, and the CFTC needed to review and approve them. To reduce the burdens of such a short timeframe, the CFTC established a "temporary registration" process designed to allow a prospective SEF applicant to operate as a SEF during the pending application review process.[38]

In the SEF Rule, the CFTC explained the temporary registration process as one where the CFTC would review SEF applications for completeness rather than substantive compliance.[39] In practice, however, the CFTC did perform a relatively substantive review of SEF applications before providing temporary registration. For example, in several instances the CFTC requested detailed changes to be made to SEF rulebooks and technology questionnaires, among other things. As a result, the temporary registration process was not as short as some had expected. For example, it took almost two months for Bloomberg SEF, the first SEF to submit an application, to be approved for temporary registration. The timeframe varied for other SEFs.

Due to the many changes that SEFs had to make to their technology systems and draft applications in response to the differences between the SEF Rule and the proposed rule, as described above, and because of the amount of time it took for SEFs to receive temporary registration, market participants did not have much time to review the application materials necessary to onboard onto SEFs. This and other issues caused significant uncertainty and commotion leading up to the October 2. 2013 SEF compliance deadline.

For example, many participants trading non-deliverable forwards and forex options on pre-SEF electronic platforms had never been under the CFTC's jurisdiction. As a result, SEFs had to provide significant client education in connection with the onboarding process to explain why the conversion to SEFs took place and why their participants needed to execute SEF onboarding agreements before October 2.[40]

The CFTC's Division of Market Oversight ("***DMO***") issued No-Action Letter No. 13-57 in response to these concerns.[41] That letter permitted SEFs to provide temporary access to market participants even if they did not sign the SEF's onboarding documentation (such as user agreements) or consent to the SEF's jurisdiction. Letter 13-57 also provided SEFs with relief from the requirement to enforce certain of their rules, which collectively allowed market participants to commence trading on SEFs without completing the onboarding process.[42] Market participants and trade associations had requested much broader relief than that which DMO granted. The relief requested would have allowed "footnote 88" platforms—which only facilitate transactions in swaps that are not subject to the trade execution requirement to continue to operate without registering as SEFs during the period in which market participants transitioned to newer, compliant platforms.

B. Clearing Issues

A significant debate arose regarding swaps that fail to clear once market participants began reviewing SEF rulebooks that were submitted to the CFTC. SEFs addressed this issue in various different ways, and initially there was little guidance from the CFTC as to how to treat such swaps.[43] Many swap dealers became concerned, for example, about SEF rules providing that swaps would be void *ab initio* if they failed to clear, because liquidity providers often have already begun laying off their risk associated with a given swap by the time it is submitted for clearing, often using automated hedging programs.[44] Thus, if a swap that fails to clear becomes void *ab initio*, the liquidity provider may end up with one swap that never became an enforceable contract and one that was hedged in reliance on the first swap, which would leave the liquidity provider with unhedged risk in a dynamic market.

Less than one week before the SEF compliance date, DMO and the CFTC's Division of Clearing and Risk e-mailed a guidance letter to all temporarily registered SEFs and SEF applicants, as well as all FCMs, DCOs and DCMs, addressing, among other things, the treatment in a straight-through-processing environment of swaps submitted for clearing that failed to clear.[45] Specifically, in the straight-through processing letter, the CFTC wrote that SEFs should have rules stating that swaps that are rejected from clearing are void *ab initio*.[46] The staff indicated that it expected clearing failure to be a "rare occurrence" because SEFs will also be required to facilitate pre-trade credit checks, meaning that SEFs must allow FCMs or clearing members to verify that a counterparty has sufficient credit to clear a trade before the trade is executed on the SEF. Because the CFTC believes that swaps will only rarely fail to clear, and because such swaps will be void *ab initio*, the straight-through processing letter also stated that market participants cannot be required to enter into "breakage agreements," which set forth terms for swaps that failed to clear. Based on its premise that failures to clear are very rare, Staff viewed "breakage agreement" requirements as an impermissible violation of the impartial access requirement and as a means to facilitate contrived failures to clear by parties seeking to avoid mandatory clearing in favor of reverting to bilateral dealings.[47]

Subsequently, the CFTC's staff issued a letter to SEFs clarifying that SEFs cannot permit the enforcement of any breakage agreements, including pre-existing agreements.[48] This letter also generally prohibits any type of "enablement mechanism" relating to any swap that is intended to be cleared. Enablement mechanisms are broadly defined to include any mechanism, scheme, functionality, counterparty filter or other arrangement that prevents market participants from interacting or trading with, or viewing the bids and offers from any other market participant on the SEF. The animating policy rationale is that the CFTC expects SEF participants to be able to trade freely with each other for swaps that are intended to be cleared. This includes permitting two non-dealer participants to transact with each other.

One of several issues unaddressed by the CFTC's straight-through processing letter or subsequent guidance is how the void *ab initio* rule will work for bunched orders. Specifically, SEFs and market participants are struggling to determine how a bunched order intended to be allocated to various accounts on a post-trade basis should be treated if one part of that trade fails to clear.

The differences between SEFs and DCMs are evident from the "failure to clear" issue. All contracts on a DCM must be cleared, but only some SEF trades will be cleared. Because a SEF is somewhat of a hybrid platform, bilateral agreements between counterparties will continue to be relevant on SEFs.[49]

C. Confirmations

Before the SEF compliance date, some market participants argued that SEFs could not create confirmations that capture all of the terms of a swap because they did not have all of the information necessary to do so. Specifically, while SEFs are able to capture the dynamic terms of a swap (*e.g.*, the primary economic terms) and occasionally incorporate certain additional terms (*e.g.*, EMTA template terms for swaps in the FX asset class[50]), some market participants claimed that SEFs do not currently have the capability to capture additional terms such as information about master agreements and non-standardized terms agreed between the counterparties. Because SEF confirmations are required to incorporate "all of the terms of the transaction" and must "legally supersede any previous agreement,"[51] these market participants argued that SEFs cannot satisfy the confirmation requirements under the SEF Rule. This deficiency could allow one of the counterparties to challenge the enforceability of the confirmation and swap.

In response, the CFTC's staff issued temporary no-action relief to SEFs from the requirement to provide a confirmation to the counterparties to non-cleared swaps for which the SEF is unable to provide a confirmation in compliance with CFTC regulations.[52] This relief expired on October 30, 2013 for FX, interest rate and credit swaps, and December 2, 2013 for equity and "other commodity" swaps. The CFTC then extended this relief for swaps in the FX asset class until November 29, 2013.[53] As of mid-December 2013, the primary FX trade committee was pursuing further discussions with the CFTC Staff.

SEFs and market participants attempted to use the time provided by these no-action letters to agree on a collective solution. As part of this, many SEFs submitted rule amendments stating that any bilateral documents and/or agreements between swap counterparties governing a SEF-executed swap would be incorporated by reference into every SEF confirmation. However, this only solved part of the problem because footnote 195 of the SEF Rule states that a SEF's confirmation can incorporate these agreement by reference "*provided that* the master agreement is submitted to the SEF ahead of execution and the counterparties ensure that nothing in the confirmation terms contradict the standardized terms intended to be incorporated from the master agreement."[54] Therefore, some believed (and the CFTC staff reiterated) that market participants must actually submit master agreement and other bilateral arrangement to SEFs in advance of swap execution in order for the SEF rulebook amendments described above to be compliant with the SEF Rule.

Submitting master agreements and bilateral arrangements to SEFs, however, raises numerous issues. For example, counterparties may be prohibited from submitting certain agreements to any third party, including a SEF, due to confidentiality provisions contained in such agreements. Additionally, the vast number of master-level agreements, and the great variety among them, would make it incredibly operationally burdensome to identify, categorize and submit all such agreements to all SEFs through which every potential pairing of two counterparties could conceivably trade. For these and other reasons, counterparties generally would prefer not to submit their agreements to SEFs, and SEFs generally would prefer not to have to receive them.

The obstacles posed by footnote 195 have yet to be definitively resolved, but many SEFs and market participants believe that they can be addressed by deeming a master agreement or other bilateral arrangement to be "submitted" to a SEF if they are "readily accessible" to the SEF. This could be accomplished by adding a rule to a SEF's rulebook requiring participants to furnish such agreements to a SEF upon request. This would also resolve any contractual confidentiality issues between the parties since they would each consent in advance to such possible disclosure through their adherence to the SEF's rulebook. More standardized terms, such as the standard ISDA provisions and EMTA terms, could be incorporated by reference into SEF product specifications. Others do not believe that this approach satisfies footnote 195, and believe that some form of relief from the CFTC is necessary while the industry develops a strategy for complying with this requirement.

D. Reporting

Some SEFs also reported that they faced difficulty satisfying the reporting requirements under Parts 43 and 45 of the CFTC's regulations. One issue related to duplicative reporting. Specifically, certain swap dealers claimed that they could not suppress their electronic systems from reporting their swaps because those systems were set up to automatically report the swap dealer's data after execution. Since both the swap dealer and SEF would be submitting data to a swap data repository ("***SDR***"), SDRs would receive duplicative reports. Other SEFs stated that they had more general problems complying with the applicable reporting requirements.

In response, CFTC staff issued no-action relief to SEFs from the requirement to report creation data to a SDR until October 30, 2013 for swaps in the FX asset class (which was subsequently extended to November 29, 2013)[55] and December 2, 2013 for equity and "other commodity" swaps.[56]

Another complication arose in connection with the confirmation issues described above, however. Namely, if SEFs only have physical access to the dynamic terms of a swap and other terms must be reported, then SEFs will not be able to transmit all of the applicable terms to a SDR. As with the confirmation issue, this problem has not been definitively resolved, but many SEFs and market participants believe that SEFs can satisfy the reporting requirements if they submit all of the terms known them, and swap dealers (or other counterparties) "correct" the SEF report by submitting any applicable additional terms they have agreed to with their counterparty. This approach would result in the CFTC having a complete and accurate report of each swap, while relieving operational burdens and ensuring that no duplicative information is filed with SDRs. However, there may be legal obstacles to counterparties "correcting" data that has already been reported to a SDR.

E. Cross-Border Issues

The CFTC issued in July 2013 extensive interpretive guidance regarding the cross-border application of the Dodd-Frank Act. This included with respect to "transaction-level requirements", such as the SEF execution requirement for Required Transactions. [57] This guidance, however, does not address the circumstances, types of cross-border activity or degree of U.S. nexus that would require a non-U.S. swaps platform to register as a SEF. On November 15, 2013, however, the DMO sent a letter to all then-registered SEFs discussing the SEF registration requirements in a cross-border context.[58] In this letter, DMO stated that the following types of platforms must register as a SEF (or DCM):

- A multilateral swaps trading platform that is itself a U.S. person (presumably based on the CFTC's definition of a U.S. person in the cross-border guidance);
- A multilateral swaps trading platform located or operating in the U.S.; and
- A multilateral swaps trading platform located outside the U.S. that provides U.S. persons or persons located in the U.S. (including personnel and agents of non-U.S. persons located in the U.S.) with the ability to trade or execute swaps on or pursuant to the rules of the platform, *either directly or indirectly through an intermediary*. (emphasis added)

The latter prong is modified by a footnote wherein DMO stated that it would "generally" evaluate whether a non-U.S. platform must register as a SEF by considering (although "not be limited to") whether: (i) the platform directly solicits or markets its services to U.S. persons or U.S.-located persons or (ii) whether a significant portion of the platform's market participants are U.S. persons or U.S.-located persons. It is unclear how the CFTC will apply this guidance in practice. It is not immediately evident that all fact patterns outlined in the guidance would be found by a Federal court using applicable precedents to have a "direct and significant connection with activities in, or effect on, commerce in the United States" within the meaning used in Dodd-Frank's limitation on extraterritorial application (Section 722). Depending on the CFTC Staff's intent, assertion of U.S. jurisdiction to the context highlighted above in italics would exceed decades-long historical precedent pursuant to which U.S. persons, and non-U.S. persons with trading personnel in the U.S., have been able to access foreign futures and securities markets through local, non-U.S. brokers, without those markets having to register in the U.S.[59]

As a result of this cross-border guidance, many trading platforms are "ring-fencing" their activities so that transactions between two non-U.S. persons (and only such transactions) are conducted on a non-U.S. trading platform. This will effectively bifurcate global liquidity into U.S. and non-U.S. pools.[60]

In addition to bifurcating liquidity pools, the CFTC's registration rules for non-U.S. platforms will likely create practical issues for non-U.S. market participants. Once swaps become Required Transactions (*i.e.*, subject to mandatory trade execution requirements), market participants subject to CFTC rules will only be able to trade those swaps on a SEF (or a DCM). In some instances, these trading requirements will apply to non-U.S. persons, such as when a non-U.S. swap dealer transacts with a non-U.S. person that is guaranteed by a U.S. person. Therefore, when these non-U.S. market participants look to enter into a Required Transaction, they will only legally be able to do so on a SEF that is likely to be located in the U.S., and therefore in a different time zone. This could severely limit the hours of the day that such non-U.S. persons can trade such swaps, unless a SEF is available in the local time zone, or a U.S.-located SEF is open all day, or the CFTC issues a "substituted compliance" determination. A "substituted compliance" determination could allow certain non-U.S. market participants to comply with the CFTC's rules, including potentially the trade execution requirement, by complying with local laws applicable to that non-U.S. market participant.

The CFTC is working with several non-U.S. regulators to create a coordinated regulatory approach to both the SEF execution mandate and SEF registration requirements.[61] Progress with respect to the latter could permit certain non-U.S. platforms to be exempt from SEF registration requirements if they are subject to comparable regulation by another regulator.[62] This system for exempt SEFs does not yet exist, however. It is unclear whether sufficient progress will be achieved before the expected advent of the first Required Transactions in February 2014.

F. SEF Aggregators

A SEF aggregator is a third party platform that provides market participants with data, such as pricing data, from multiple SEFs and/or provides a portal for market participants to access liquidity on multiple SEFs. SEF aggregators may also have an affiliate or division that receives RFQs submitted through the aggregator platform, which would permit the SEF aggregator to provide responsive quotes to the RFQ.[63]

The use of SEF aggregators raises several issues. For example, some liquidity providers have considered creating aggregator platforms (which would likely be a division or affiliate of the liquidity provider) that would automatically send any RFQs to the liquidity provider running the platform. This could create potential conflicts of interest, since the liquidity provider might have access to the responsive quotes provided by other liquidity providers.[64] However, the SEF Rule does not impose any responsibilities on SEF aggregators to avoid or mitigate conflicts of interest. Indeed, the SEF Rule does not impose any obligations on SEF aggregators. Additionally, it is unclear whether a SEF aggregator would be required to show all responsive quotes to its users, or whether, for example, it could show only the best quote. Finally, while SEF aggregators should be subject to the jurisdiction and oversight of any SEFs with which they are connected (by virtue of being SEF members), it is unclear what authority the CFTC would have over SEF aggregators since they would not be registered entities.

G. Packaged Transactions

Solutions are needed to preserve the economic utility of packaged transactions. These are bona fide transactions between a single dealer and its counterparty that have two or more components, one of which is a swap that is (or will be) a Required Transaction. At least one other transaction component is either a Permitted Transaction or not a "swap", e.g., a SBS or an exempted FX swap, securities option or securities forward. The component sizes are reasonably correlated so as to demonstrate the close connection, integration and bona fides.

Such transactions long predated Dodd-Frank and exist for legitimate commercial reasons, including between financial participants that are not eligible for the end-user clearing exemption. The pricing reflects that fact that execution of one component between the parties is partial consideration for the other component(s). This is due to various risk-return efficiencies that can be achieved through a coordinated execution of all components through a single dealer. Execution of the entire transaction on a single SEF may be impossible. Forced SEF execution of the bifurcated SEF-capable component(s) would destroy these important commercial benefits and achieve little discernible Dodd-Frank public policy benefit. Even some SEFs have indicated that such transactions should not be forced to become Required Transactions. An appropriate solution would be to exempt the swap components of packaged transactions from mandatory SEF execution, so long as the bilateral execution of all swap components is properly reported to the SDR.

H. Agency Execution for Customers

With approximately twenty SEFs currently temporarily registered with the CFTC and functional, it is unlikely that all major dealers and other market participants will be members of all SEFs necessary to execute all conceivable swaps between them that they either wish or are required to trade on-SEF. This seems particularly so from a customer perspective, given the typical SEF onboarding process. Thus as Permitted Transactions increasing morph into Required Transactions, it is likely in 2014 that dealer participants will have to find various ways to both (i) facilitate customer transactions using the dealer's participation on relevant SEFs and (i) deal through other dealers as a customer when a given dealer needs to execute a swap that is traded on a SEF on which such dealer is not a participant.

This can be achieved through various means. A SEF may permit a participant to provide direct market access to certain customers or facilitate individual customer transactions on the SEF case-by-case. Either approach entails additional documentation requirements since the customers need to be subject to the SEFs jurisdiction and rulebook. Because the indemnification provisions that many SEFs require in their rulebooks from participants also cover acts and omissions by a participant's customers when trading through the participant's SEF membership, participants need to exercise underwriting care in determining which customers to enable for this capability, and to obtain adequate indemnifications or guarantees in corresponding customer or execution agreements.

III. CONCLUSION AND OUTLOOK

SEFs have been operating for several months, but several significant issues remain unresolved. Certain of the no-action letters and interpretations regarding SEFs were well-received by market participants, while others created more uncertainty. The CFTC is expected to continue its dialogue with SEFs and market participants. Interpretations and policies that foster liquidity and competitiveness of U.S. markets are essential.

As SEFs work through these issues in 2014, some dramatic changes in the SEF environment are likely. Some SEFs may not survive (or may merge with other SEFs) as one or two SEFs emerge as the dominant forces in a given asset class. Additionally, SEFs that currently facilitate trading in one asset class, or a limited number of asset classes, may begin offering other types of swaps. This would cater to some market participants' desire to have fewer sources for trading, as demonstrated by the broad array of contacts offered by DCMs.

Standardized swaps that are suitable for trading through an order book may also become predominantly traded on DCMs. If this occurs, it is likely that these standardized swaps would become futures, since the margin requirements are lower for futures compared to swaps. In such case, for these swaps SEFs may be primarily used for their RFQ and block trade functionalities. In order to prevent SEFs from becoming irrelevant, then, the CFTC could relax execution methods for SEFs in order to attract more liquidity. It is also possible (although not likely for 2014) that the CFTC would create a "SEF-light" category similar to that applicable to commodity pool operators, or an exempt SEF category for which additional execution methods would be permitted. Relatedly, the CFTC may determine to exempt certain regulated non-U.S. platforms, such as multilateral trading facilities ("***MTFs***"), from the SEF registration requirements.

Finally, a hybrid model in which participants use SEF aggregators, white label platforms and/or dealer portals in order to access SEFs may emerge, and may also be integrated into some SEFs. Unless SEFs are able to capture dealer liquidity, they will have a very difficult time finding and maintaining their space between purely OTC trades and DCMs. Liquidity will be crucial, because the SEFs that survive will be those that succeed in capturing liquidity.

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END NOTES

1. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, 124 Stat. 1376 (2010). As used in this article, "swap" has the meaning used in Dodd-Frank (Section 721 (21)) and a joint regulation (the "***Products Definition***") of the CFTC and the Securities and Exchange Commission (the "***SEC***"). *See* Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping; Final Rule, 77 Fed. Reg. 48208 (Aug. 13, 2012). Dodd-Frank and the Products Definition distinguish "swaps" and "security-based swaps" ("***SBS***"), which are regulated by the CFTC and SEC, respectively, according to broadly parallel regimes. This article focuses on the execution of swaps on SEFs. The SEC has a proposed regulation with respect to "security-based swap execution facilities" ("***SB-SEFs***"). *See* Registration and Regulation of Security-Based Swap Execution Facilities, 76 Fed. Reg. 10948 (Feb. 28, 2011). For some relevant distinctions between the SEF Rule and the SEC's SB-SEF proposal, *see* James E. Schwartz, Marissa N. Golden & Robert J. Dilworth, *First Steps on the Path Forward*, 32 Int'l Fin. L. Rev. 36 (September 2013), *available at* "http://www.iflr.com/Article/3247985/The-path-forward-for-EU-US-derivatives-regulation.html."
2. This trade execution requirement is included in Section 2(h)(8) of the Commodity Exchange Act (the "***CEA***") as amended by Dodd-Frank. As so amended, the counterparties to any swap that is subject to the clearing requirement must execute the swap on a swap execution facility ("***SEF***") or designated contract market ("***DCM***") unless (i) no SEF or DCM "makes the swap available to trade" or (ii) the end-user exception is available and is elected. *See* CEA § 2(h)(8), 7 U.S.C. § 2(h)(8). Swaps that are subject to the clearing requirement and the trading mandate are referred to by the CFTC and herein as "Required Transactions." Swaps that are not Required Transactions are referred to by the CFTC and herein as "Permitted Transactions." Permitted Transactions may be executed on a SEF or DCM, but may also be executed in any lawful manner, such as bilaterally or OTC.
3. Core Principles and Other Requirements for Swap Execution Facilities; Final Rule, 78 Fed. Reg. 33476, 33552 (June 4, 2013).
4. *See* G-20 Leaders' Statement: The Pittsburgh Summit, September 2009. The statement is available at: "http://www.g20.org/load/780988012."
5. S. Rep. No. 111-176, at 34 (2010).
6. *See* Core Principles and Other Requirements for Swap Execution Facilities; Final Rule, 78 Fed. Reg. at 33583; *see also* 17 C.F.R. § 37.3(a)(1).
7. Even though many of these platforms were previously qualified as ECMs, ETFs and EBOTs, the SEF registration requirement is a completely new regime. These existing platforms thus had to re-qualify as SEFs. This was typically done by creating a SEF affiliate, obtaining provisional SEF registration from the CFTC, onboarding existing customers and conducting business only on the SEF as of October 2, 2013.
8. *See* Grain Futures Act, Pub. L. 67-331, 42 Stat. 998 (1922).
9. *See* 17 C.F.R. § 37.3(a).
10. *See* SEF Rule, 78 Fed. Reg. at 33481 n.88. Notably, the CFTC clarified that if a facility offers a trading system or platform *solely* for the execution of foreign exchange swaps or foreign exchange forwards that are exempt from the "swap" definition under the Treasury Secretary's written determination (as was permitted by Dodd-Frank and so granted), the

facility would not be required to register as a SEF.

11. *See id.* A non-clearable swap may be executed OTC, but if a platform that facilitates execution of such swap independently qualifies as a SEF, the platform must register as a SEF. This legal construct is consistent with the CFTC's previous body of law that required ECMs, ETFs, EBOTs and DTEFs to be exempt, excluded or registered as such.
12. *See id.* at 33482.
13. *See id*.
14. *See id*. The CFTC noted, though, that to the extent an aggregation service or portal itself provides a trading system or platform whereby more than one market participant has the ability to execute or trade swaps with more than one other market participant on the system or platform, the aggregation service would be required to register as a SEF.
15. *See id*.
16. *See id*. at 33483. With regard to swap processing, CEA Section 5h states that no person may operate a facility for the trading "or processing" of swaps unless it is registered as a SEF. See CEA § 5h(a)(1), 7 U.S.C. § 7b-3(a)(1). However, the CFTC stated in the SEF Rule that entities solely engaged in "trade processing" would not meet the SEF definition because they do not provide the ability to execute or trade a swap. *See* SEF Rule, 78 Fed. Reg. at 33483.
17. *See* 17 C.F.R. § 37.3(a)(2)
18. *See* Core Principles and Other Requirements for Swap Execution Facilities; Proposed Rule, 76 Fed. Reg. 1214, 1241 (Jan. 7, 2011).
19. *See* SEF Rule, 78 Fed. Reg. at 33498.
20. There is significant controversy over how voice brokerage systems can be incorporated in the SEF trading environment. Some SEFs have been able to accommodate voice execution for Permitted Transactions directly through a SEF by treating voice brokers as its own employees. The CFTC has noted, however, that voice brokerage systems that are unaffiliated with a SEF may qualify as SEFs themselves under footnote 88 of the SEF Rule.
21. *See* 17 C.F.R. § 37.3(a)(2). This requirement has been referred to as a SEF's "minimum functionality."
22. SEF Rule, 78 Fed. Reg. at 33504.
23. Some market participants believe that a conference call system could qualify as an order book platform because it is similar to pit trading, which would have qualified as an order book under previous CFTC interpretations.
24. *See* CEA § 2(h)(8), 7 U.S.C. § 2(h)(8); *see* also note 2, supra. Some inter-affiliate swaps may also be excepted from the clearing and trading requirements. *See* Clearing Exemption for Swaps Between Certain Affiliated Entities; Final Rule, 78 Fed. Reg. 21750 (April 11, 2013).
25. Process for a Designated Contract Market or Swap Execution Facility To Make a Swap Available to Trade, Swap Transaction Compliance and Implementation Schedule, and Trade Execution Requirement Under the Commodity Exchange Act; Final Rule, 78 Fed. Reg. 33606, 33613 (June 4, 2013).
26. *See* 17 C.F.R. §§ 40.5, 40.6.
27. *See* Swaps Made Available to Trade Determination, available at http://sirt.cftc.gov/sirt/sirt.aspx?Topic=SwapsMadeAvailableToTradeDetermination.
28. *See*, e.g., Remarks of Chairman Gary Gensler at a D.C. Bar Event–"A Transformed Marketplace" (Dec. 11, 2013).
29. *See* MAT Rule, 78 Fed. Reg. at 33614.
30. *See* MAT Rule, 78 Fed. Reg. at 33616.
31. *See* 17 C.F.R. § 37.9(b).
32. *See* SEF Rule, 78 Fed. Reg. at 33503. SEFs are required to have rules addressing permitted pre-execution communications between participants. *See id*.
33. *See id*.
34. *See id*.
35. For example, SEFs may only list contracts that are not readily susceptible to manipulation, and must monitor trading in all contracts to prevent manipulation. The products listed by FX SEFs often rely on or reference certain industry-standard terms, such as those produced by the Emerging Markets Trade Association ("**EMTA**"). However, if a SEF references terms such as the EMTA-specified fixing source in its product filings, such SEF may have to demonstrate that those terms are not readily susceptible to manipulation. Since these terms are created by third parties, a SEF may have difficulty determining how to observe this requirement.
36. *See id*. at 33509. In fall 2013, CFTC Chairman Gary Gensler publicly admonished certain SEFs that were open only to dealers. According to Chairman Gensler, these types of platforms are incompatible with the requirement that SEFs provide impartial access to their platforms.
37. *See id*. at 33522.
38. *See* SEF Rule, 78 Fed. Reg. at 33487-89. Temporary registrations are valid for up to two years. *See id*.
39. *See id*. at 33487 ("The Commission notes that it will review a SEF applicant's Form SEF to ensure that it is complete, and will not conduct any substantive review of the form before granting or denying temporary registration.").
40. *See* 17 C.F.R. § 37.202 (setting forth access requirements and rules requiring SEF participants to submit to the SEF's jurisdiction).

41. CFTC No-Action Letter 13-57 (Sept. 27, 2013).
42. Specifically, Letter 13-57 provided SEFs with relief from the requirement to comply with the following CFTC rules: 37.200(a): Requirement to establish and enforce rules; 37.200(b): Requirement to establish and enforce trading, trade processing, and participation rules; 37.201(b)(1): Requirement to establish and enforce terms and conditions of swaps traded on the platform; 37.201(b)(3): Requirement to establish and enforce trade practice rules; 37.201(b)(5): Requirement to establish and enforce disciplinary rules; 37.202(b): Requirement that participants consent to the SEF's jurisdiction; 37.203: Rule enforcement program requirements.
43. In one rule, the CFTC stated that "a swap that fails to clear because of credit issues may not be voided by either eligible counterparty solely for the failure of the swap to be cleared in accordance with section 2(h)(1), but the basis for the failure to clear must be addressed by the counterparties and they must promptly resubmit the swap for clearing." Clearing Requirement Determination Under Section 2(h) of the CEA; Final Rule, 77 Fed. Reg. 74284, 74288 (Dec. 13, 2012).
44. One alternative to swaps being void ab initio would be for swaps that fail to clear to result in an uncleared swap that would be settled according to a bilateral agreement (if the counterparties have such an agreement) or pursuant to the SEF's rules. The CFTC objected to this method in the straight-through processing letter (discussed below)..
45. *See* Staff Guidance on Straight-Through Processing (Sept. 26, 2013).
46. In a subsequently-released no-action letter, however, the CFTC's staff stated that SEFs may permit counterparties to a swap that fails to clear due to a clerical or operational error or omission resulting in a mismatch of the terms to submit for clearing a new trade on the same exact terms, provided that the SEF's rules satisfy several conditions.
47. In the straight-through processing letter, the CFTC staff also took the following positions: (i) FCMs that are clearing members of a DCO (Clearing FCMs) must screen orders submitted for execution on SEFs, regardless of the method of execution to be used, (ii) SEFs must facilitate pre-execution screening by each Clearing FCM on an order-by-order basis, (iii) Clearing FCMs may not reject swaps that have passed their pre-execution filters, (iv) SEFs can use third party affirmation hubs for routing swaps to clearing, but only if the swap will be routed for clearing as quickly after execution as would be possible if fully automated systems were used, and (v) DCOs must accept or reject swaps that were executed competitively on a SEF and are submitted for clearing within 10 seconds of submission to the DCO. *See* Staff Guidance on Straight-Through Processing.
48. *See* Division of Clearing and Risk, Division of Market Oversight and Division of Swap Dealer and Intermediary Oversight Guidance on Application of Certain Commission Regulations to Swap Execution Facilities (Nov. 14, 2013).
49. Note that uncleared transactions that are executed on a SEF on a disclosed basis (i.e., other than on an anonymous order book) are subject to several swap trading relationship documentation requirements. *See* 17 C.F.R. §§ 23.500-506.
50. *See* FX and Currency Derivatives Current Templates, available at "http://www.emta.org/ndftt.aspx."
51. *See* 17 C.F.R. § 37.6(b).
52. *See* CFTC No-Action Letter 13-58 (Sept. 30, 2013). A SEF relying on this relief must: (i) notify the counterparties to any swap that it is doing so and (ii) arrange with the counterparties to ensure that they provide the SEF with a confirmation in order to allow the SEF to comply with its reporting and recordkeeping obligations.
53. *See* CFTC No-Action Letter 13-68 (Nov. 1, 2013).
54. SEF Rule, 78 Fed. Reg. at 33491 n.195.
55. *See* CFTC No-Action Letter 13-68 (Nov. 1, 2013).
56. *See* CFTC No-Action Letter 13-55 (Sept. 27, 2013).
57. *See* Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations; Rule, 78 Fed. Reg. 45292 (July 26, 2013). This guidance was recently challenged in court by a group of industry associations. *See* Complaint, Securities Industry and Financial Markets Assoc. v. CFTC, No. 13-CV-1916 (D.D.C. Dec. 4, 2013).
58. *See* Division of Clearing and Risk Guidance on Application of Certain Commission Regulations to Swap Execution Facilities (Nov. 15, 2013).
59. *See* Robert J. Dilworth and Colin D. Lloyd, Bumps on the Path Forward, 39 Int'l Fin. L. Rev. 40 (December 2013–January 2014), available at "http://www.iflr.com/bumpypathforward." This article discusses in greater detail the trade execution, multilateral trading platform registration, mandatory clearing and trade reporting requirements in the cross-border context and provides several examples in which current CFTC and proposed European Union approaches fragment market liquidity unnecessarily relative to achievement of the primary policy goals.
60. If U.S. persons were to trade swaps on a non-U.S. platform, that non-U.S. platform may be

required to register with the CFTC as a SEF or a foreign board of trade ("**FBOT**") or a SEF. *See* 17 C.F.R. pt. 48.

61. *See* Staff Guidance on Straight-Through Processing at 3; The European Commission and the CFTC reach a Common Path Forward on Derivatives (July 11, 2013) (". . . the CFTC will consult with the EC in giving consideration to extending regulatory relief to trading platforms that are subject to requirements that achieve regulatory outcomes that are comparable to those achieved by the requirements for SEFs.").

62. This exemption could be made under Section 5h(g) of the CEA, which permits the CFTC to exempt a SEF from registration if the CFTC finds that the facility is subject to comparable, comprehensive supervision and regulation by, among other things, a non-U.S. regulator. *See* CEA § 5h(g), 7 U.S.C. § 7b-3(g).

63. It is unclear at this time whether the CFTC will permit this arrangement for SEF aggregators.

64. The SEF Rule state that the liquidity providers (or RFQ recipients) may not be "affiliates of or controlled by the requester and shall not be affiliates of or controlled by each other," 17 C.F.R. § 37.9(a)(3), but this does not prohibit liquidity providers from being affiliates of a SEF aggregator.