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Client Alert Commentary

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CFTC Issues Guidance, Exemptions In Advance of SEF Rule Compliance Date

Staff responds to industry concerns and confusion surrounding SEF operations and onboarding.

One of the key aspects of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) is the trade execution requirement, under which the execution of certain swaps transactions will be required to take place on open, transparent platforms. The trade execution requirement states that if a swap is subject to the clearing mandate (meaning it must be centrally cleared unless an exception from clearing, such as the end-user exception, is available), and any swap execution facility (SEF) or designated contract market (DCM) makes it "available to trade," then it must be traded on a SEF or DCM. Although no swaps have yet been designated as "made available to trade" and the effectiveness of the trade execution requirement is thus likely several months away, the establishment of SEFs as new marketplaces for swap trading, along with revisions to DCM regulations to accommodate the new rules for swaps and other statutory changes, is creating fundamental changes in the trading market for swaps.

Although DCMs, which are the major commodity and futures exchanges, already existed when Congress adopted the Dodd-Frank Act, SEFs *per se* did not exist. The Dodd-Frank Act defined a "swap execution facility" as 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."[1] Because of this definition, SEFs are sometimes referred to as "multiple-to-multiple" platforms, meaning that they can be used by multiple buy-side participants and by multiple sell-side participants. This is in contrast to "single-dealer platforms," on which a single dealer provides market liquidity. Although "multiple-to-multiple" trading platforms that facilitated swap transactions did exist when the Dodd-Frank Act was adopted, none of them had been established to conform to the core principles set out in the Dodd-Frank Act or the rules (the SEF Rules)[2] that were later adopted by the Commodity Futures Trading Commission (CFTC). Multiple-to-multiple platforms meeting the requirements of the SEF Rules are required to register as SEFs with the CFTC, and those that do not register are required to cease operations, effective as of October 2, 2013. The registration requirement applies to any multiple-to-multiple electronic or voice-execution venues where participants can execute swaps.

The SEF Rules were not finalized until May 2013, nearly three years after the Dodd-Frank Act was adopted, and they deviated in a number of ways from the proposed rules. Moreover, although market participants had been working both to establish new platforms that could be registered as SEFs and to make changes to existing platforms — either to bring them into compliance with the SEF Rules or to eliminate any features that could cause them to be considered a multiple-to-multiple platform for swap execution — that work was being done without a clear understanding of what the final rules would

require. SEFs have had relatively little time, following the adoption of final rules, to finalize rulebooks, establish clearing and reporting arrangements, and develop and test critical technological interfaces. Moreover, the SEFs have been taking these steps in a shifting regulatory environment in which the registration process has surfaced new compliance issues. Other market participants, including swap dealers, clearing members and derivatives clearing organizations (DCOs), have also faced challenges as they try to understand the rules of a large number of new infrastructure entities. Moreover, SEFs are self-regulatory organizations and their members must submit to their enforcement jurisdiction. So far, at least 19 have applied for, or been granted, temporary registrations and their organizational documents are complex, divergent, developing, and have only been available to the public for a brief period. A number of market participants, including but not limited to SEFs, have asked the CFTC for relief from certain SEF-related requirements due to practical complications arising from this situation. As both the October 2, 2013 deadline and a government shut-down loomed, the CFTC released 10 no-action letters in two business days[3] and issued two letters with interpretive guidance that spoke directly to SEFs. Below is a brief digest of each of these CFTC staff letters.

Straight-Through Processing Letter

Less than one week before the SEF compliance date, the CFTC's Division of Clearing and Risk and Division of Market Oversight emailed a letter to all temporarily registered SEFs and SEF applicants, as well as all FCMs, DCOs and DCMs, addressing the process by which swaps executed on a SEF should be submitted for clearing and the consequences of a failure to clear. The guidance reflected a significant change in course from the positions articulated by the CFTC staff in previous discussions with SEFs and other market participants. In the straight-through processing letter, the CFTC staff took the following positions:

- Futures commission merchants (FCMs) that are clearing members of a derivatives clearing organization (Clearing FCMs) must screen orders submitted for execution on SEFs, regardless of the method of execution to be used.
- SEFs must facilitate pre-execution screening by each Clearing FCM on an order-by-order basis.
- Clearing FCMs may not reject swaps that have passed their pre-execution filters.
- 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.
- SEFs, DCMs, FCMs and swap dealers should not require participants to have breakage agreements for swaps that fail to clear as a condition for access to the SEF or DCM.
- SEFs should have rules stating that swaps that are rejected from clearing are void *ab initio*.
- Derivatives clearing organizations (DCO) 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.

SEF Rulebooks Letter

On September 30, 2013, the CFTC's Division of Market Oversight (DMO) emailed another letter to all of the temporarily registered SEFs and SEF applicants. In this letter, while noting that the staff had not undertaken "a substantive review of SEFs' rulebooks in connection with the temporary registration process," DMO nonetheless found it necessary to point out that some of these rulebooks contained provisions that DMO considers inconsistent with CFTC rules. In other words, they decided not to delay temporary registration for SEFs with these provisions, but want the provisions changed. The following is the list of points the staff emphasized:

- SEFs should not define the term "member" to include customers or clients of persons that have neither a membership interest in a SEF nor any trading privileges on a SEF. Therefore, such

customers and clients should not be considered to be subject to the SEF's rules. Customers of independent software vendors (ISVs), such as aggregation platforms, must still be bound by the rules of a SEF under the SEF Rules if they have trading privileges through the ISV.

- SEFs should include exceptions in their rulebooks allowing investment and/or trading advisors to aggregate orders for different accounts to satisfy the block trade size requirements, as permitted by CFTC Rule 43.6(h)(6).
- SEFs must have the authority to liquidate or transfer open positions to address perceived market threats, and should allow the SEF to take emergency actions including imposing special margin requirements. However, SEFs should only utilize this authority in the event of an emergency and not normal business operations. Moreover, any emergency actions taken by a SEF must be filed as a rule under Part 40 of the CFTC's regulations.
- SEFs are obligated to report data for block trades to a registered swap data repository (SDR).
- The time delay requirement, or so-called "15-second rule" — which requires a broker-dealer that seeks to execute against its customer's orders or to execute two of its customers' orders against each other — only applies to transactions where there is some form of pre-arrangement or pre-negotiation. SEFs that allow this type of pre-execution communication must adopt rules regarding such communications and must subject the orders that result from such communication to a time delay.

Letter 13-55: Relief for SEFs from Certain Reporting Requirements

- Overview: Certain SEFs stated that they would be unable to comply fully with requirements to report swaps as required by Parts 43 (real-time reporting) and 45 (regulatory reporting) of the CFTC's regulations by October 2, 2013. Additionally, SEFs stated that some swap dealers (who have been reporting swaps executed on electronic platforms for months) would not be able to suppress their reporting data streams, so SDRs would receive duplicative reports if SEFs created their own reports. In response to these concerns, the CFTC provided SEFs with short-term relief for swaps in certain asset classes from certain reporting requirements and from the so-called "embargo rule," which prohibits a SEF from disclosing transaction and pricing data to its members before it has reported that data to an SDR.
- Reporting relief: Letter 13-55 provides SEFs with relief from the requirement to report creation data (*i.e.*, primary economic terms data and confirmation data) to an SDR until 12:01 a.m. Eastern time on October 30, 2013 for swaps executed in the foreign exchange (FX) asset class, and until 12:01 a.m. Eastern time on December 2, 2013 for swaps executed in the equities and other commodity asset classes. No relief is provided for reporting swaps in the credit or interest rate asset classes, which are currently clearable.
- Conditions for relying on reporting relief: If a SEF cannot report swap creation data as required under Part 45, then it must:
  - Ensure that either the reporting counterparty to the swap reports the data, or report the data itself, by backloading the Part 45 report as soon as the SEF is able to report the data, pursuant to the following schedule:
  - Swaps in the FX asset class must be backloaded by December 2, 2013
  - Equities and other commodity swaps must be backloaded by January 2, 2014
  - Retain records of all transactions covered by the relief and make such records available to the CFTC;
  - Comply with all recordkeeping requirements applicable to SEFs;
  - Provide a notice to the CFTC by October 10, 2013 of the SEF's intent to rely on this no-action relief, which notice must contain several details regarding the SEF's reporting capabilities; and
  - Obtain a CFTC Interim Compliant Identifier (CICI) for the SEF.

- Embargo rule relief: As noted above, CFTC Rule 43.3(b)(3) (the embargo rule) prohibits SEFs from disclosing transaction and pricing data of a swap executed on the SEF until the SEF has transmitted that data to an SDR. Letter 13-55 permits SEFs to disclose transaction and pricing data to participants even though the SEF has not transmitted the creation data to an SDR in reliance on this no-action letter.

Letter 13-56: Relief from Continuation Data Reporting (Part 45)

- Overview: Market participants such as swap dealers and reporting financial entities asserted that they would be unable to fulfill certain responsibilities to report continuation data for SEF-executed, uncleared swaps if the SEF does not report creation data because the SEF is relying on Letter 13-55 (described above).
- Relief: Letter 13-56 grants relief to reporting counterparties from the requirement to report continuation data for SEF-executed, uncleared swaps in the FX, equity and other commodity asset classes so long as the reporting counterparty:
  - Fails to report this data due to the SEF's failure to provide the reporting counterparty with certain information;
  - Fails to report this data as a result of the SEF "backloading" its data, rather than reporting it directly to an SDR, in reliance on Letter 13-55; or
  - Reports data to an SDR with errors or omissions that are the result of the SEF's failure to provide the reporting counterparty with certain information or result from errors or omissions in the swap creation data reported to the SDR.

- Conditions: The reporting counterparty must inform the SEF of the circumstances precluding it from reporting continuation data, and must maintain records with respect to all transactions covered by the relief.
- Term: This relief ends on the earlier of the time the reporting counterparty is able to comply or (i) on October 29, 2013 for swaps within the FX asset class or (ii) on December 1, 2013 for swaps within the equity or other commodity asset class. Note, however, that backloaded data does not have to be provided by these dates. Thus, it appears that the relief may expire before the reporting counterparty has access to the data necessary to fulfill its own requirements.

Letter 13-57: Relief for SEFs from Onboarding and Enforcement Obligations

- Overview: Certain SEFs informed the CFTC that market participants have not had an adequate amount of time to review SEF rulebooks and user agreements in order to agree to all of the terms contained therein, adopt their own policies and procedures and make technological changes by October 2, 2013. In response to these concerns, DMO granted temporarily registered SEFs relief from certain requirements to onboard their participants and enforce their rules until 12:01 a.m. Eastern time on November 1, 2013.
- Onboarding relief: Letter 13-57 permits SEFs to provide temporary access to any market participants who do not sign onboarding documentation (such as user agreements) or consent to the SEF's jurisdiction.
- Enforcement relief: Letter 13-57 also provides SEFs with relief from complying with the following rules (which collectively are intended to allow participants to trade on SEFs without going through the onboarding process):
  - 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.

Market participants and trade associations had requested much broader relief than 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 that market participants transitioned to newer, compliant platforms. The DMO opted for this narrow relief instead of the broad relief requested by some.

Letter 13-58: Relief for SEFs from Confirmation Requirements for Non-Cleared Swaps

- Overview: SEFs and swap dealers informed CFTC staff that SEFs do not have all of the information necessary to capture all of the terms of a transaction that will not be submitted for clearing in a confirmation because they do not have information about bilateral agreements and non-standardized terms agreed between the counterparties. DMO granted time-limited relief to SEFs.
- Relief: Letter 13-58 grants relief to SEFs from the requirement to provide a confirmation to the counterparties to non-cleared swaps in any asset class for which the SEF is unable to provide a confirmation in compliance with CFTC regulations. This relief ends at 12:01 a.m. Eastern time on October 30, 2013 for swaps within the FX, interest rate and credit asset classes, and December 2, 2013 for swaps within the equity or other commodity asset classes. The relief is not applicable to swaps that are subject to the clearing determination but are not cleared because of an available exemption or exception.
- Conditions: In order to rely on Letter 13-58, a SEF must:
  - Provide notice to the counterparties that the SEF has not confirmed the swap transaction (as a result of this notice, if one of the counterparties is a swap dealer, that counterparty must execute a confirmation instead of the SEF); and
  - 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.

Letter 13-59: Relief for Yieldbroker, an Australian Exchange

- Overview: Yieldbroker Pty Limited (Yieldbroker) is an Australian exchange that permits US persons to trade swaps on the platform via direct access. Yieldbroker submitted a SEF application and an alternative compliance plan to the CFTC prior to October 2, 2013 but the CFTC had not reached a determination on either of those submissions in time to meet the SEF compliance date.
- Relief: Letter 13-59 grants Yieldbroker relief from the requirement to register as a SEF until November 1, 2013 at 12:01 a.m. eastern time.

This letter underscores the CFTC's views that any non-US platform located overseas that provides direct trading privileges to US participants overseas must register as a SEF.[4]

Letter 13-60: Relief from the One Business Day Review Period for Listing Swaps

- Overview: CFTC Rule 40.2(a)(2) requires SEFs that propose to list a new swap product pursuant to that rule to provide notice and a copy of the terms and conditions of the swap one business day prior to making the product available for trading. SEFs asserted that they faced logistical problems

providing these notices for all swaps they were listing in time for the October 2, 2013 deadline, and DMO granted very brief relief.

- Relief: Letter 13-60 permits SEFs to list swaps for trading on the same day that they submit a self-certification filing pursuant to CFTC Rule 40.2, with such permission expiring on the later of October 3, 2013 or the first business day following the end of the government shutdown.

Letter 13-61: Extension of Relief for Floor Traders

- Background: Under CFTC rules, floor traders may exclude swaps executed on SEFs or DCMs from the calculations used to determine if such floor traders must register as swap dealers. Since SEFs were not yet operational when these rules went into effect, though, the CFTC previously granted relief to floor traders in CFTC Letters 12-60 and 13-37, allowing them to exclude certain swaps that are submitted for clearing from these calculations. Market participants requested that the CFTC further extend this relief because many expect there to be only limited liquidity on SEFs at the outset.
- Relief: Letter 13-61 extends the no-action relief provided by CFTC Letters 12-60 and 13-37 until November 1, 2013, allowing floor traders (or any other entity that satisfies the below conditions) to exclude from their *de minimis* calculations swaps that are submitted for clearing.
- Conditions: In order to rely on Letter 13-61, an entity must:
  - Not have a registered swap dealer affiliate;
  - Have entered into the swap using proprietary funds for its own account;
  - Not directly, or through an affiliated person, negotiate the terms of swap agreements, other than price and quantity or to participate in a request for quote process subject to the rules of a designated contract market or a swap execution facility;
  - Not directly or through an affiliated person offer or provide swap clearing services to third parties;
  - Not directly or through an affiliated person enter into swaps that would qualify as hedging physical positions or hedging or mitigating commercial risk (except for any such swap executed opposite a counterparty for which the transaction would qualify as a bona fide hedging transaction);
  - Not participate in any market making program offered by a DCM or SEF;
  - Comply with recordkeeping and risk management requirements for each such swap as if it were a swap dealer; and
  - File a notice with the CFTC prior to October 2, 2013 that such entity is relying on Letter 13-61 (unless the entity previously filed a notice that it was relying on CFTC Letters 12-60 and 13-37, in which case the entity need not file a new notice).

Letter 13-62: Relief from Pre-Execution Credit Check Requirements for SEFs and FCMs

- Overview: As described above, FCMs are required to establish risk-based limits and screen orders for compliance with those limits, and SEFs must enable Clearing FCMs to satisfy this requirement by facilitating the pre-execution credit checks for swaps on an order-by-order basis. The latter requirement was only recently communicated to SEFs, so the CFTC staff issued a no-action letter to SEFs to enable them to update their rulebooks and implement the means to facilitate such pre-execution screening.
- Pre-execution credit check relief: Letter 13-62 relieves SEFs that do not already have the ability to facilitate pre-execution screening of swaps by FCMs on an order-by-order basis from the requirement to do so, until November 1, 2013 at 12:01 a.m. Eastern time, and likewise relieves FCMs of the obligation to complete such pre-execution screening during such period on any SEF that does not facilitate pre-execution screening on an order-by-order basis. The CFTC recognized that SEFs may satisfy this requirement by contracting with third party services providers.

- Conditions: In order to rely on Letter 13-62, a SEF must submit the following to the CFTC, no later than October 10, 2013:
  - Any rule amendments that are necessary for the SEF to be in full compliance with the requirement to facilitate pre-execution credit checks; and
  - A representation that the SEF is taking all steps necessary to fully comply with such requirement.

No additional conditions are imposed on FCMs.

Conclusion

So far, the transition to trading on SEFs appears to be challenging for SEFs, market participants, DCOs and regulators. Although the CFTC staff has addressed some of the concerns that have been raised through these no-action letters and interpretations, compliance questions and operational issues remain. The CFTC is expected to continue its dialogue with market participants after the end of the government shutdown.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Peter Y. Malyshev
peter.malyshev@lw.com
+1.202.637.1087
Washington, D.C.

Ellen L. Marks
ellen.marks@lw.com
+1.312.876.7626
Chicago

Jonathan T. Ammons
jonathan.ammons@lw.com
+1.202.637.1088
Washington, D.C.

Brett M. Ackerman
brett.ackerman@lw.com
+1.202.637.2109
Washington, D.C.

Endnotes

[1] CEA § 1a(50), 7 U.S.C. § 1a(50).

[2] *See* 17 C.F.R. § 37.3(a)(1).

[3] This figure includes two no-action letters that were specifically directed to one trading platform that is registering as a designated contract market, which are not discussed in this Client Alert. We note that the CFTC did not issue an extension of its previous exemptive orders and no-action letters applicable to EBOTs and ECMs. *See* CFTC No-Action Letter No. 12-48 (Dec. 11, 2012); Second Amendment to July 14, 2011 Order for Swap Regulation, 77 Fed. Reg. 41260 (July 13, 2012); Amendment to July 14, 2011 Order for Swap Regulation, 76 Fed. Reg. 80233 (Dec. 23, 2011); Effective Date for Swap Regulation, 76 Fed. Reg. 42508 (July 19, 2011). Instead, the CFTC issued these very specific, time-limited no-action letters that generally address technical implementation issues and concerns.

[4] Branches of US swap dealers or banks are considered to be US persons.