SEFs: Legal Issues and Developments

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Gregory A. Todd - Associate General Counsel

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SEFs-Legal Issues and Developments
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Regulatory Landscape

Global Origins and Basic Definition

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- **Global Reach of Exchange Execution Mandates:**
  - 2009 G-20 commitments included a commitment to trade all standardized OTC derivative contracts on exchanges or electronic trading platforms, where appropriate, by the end of 2012
  - Many G-20 countries, including the EU, US, Canada, Mexico, Japan and Singapore, plan to adopt or have adopted exchange or electronic trading mandates
  - The US moved first, adopting a registration requirement for a new type of execution platform called a "swap execution facility" (SEF), and requiring certain standardized interest rate and credit derivative products to be traded on either "designated contract markets" (DCMs) (legacy futures exchanges) or SEFs
  - SEFs have become the primary platform through which market participants have chosen to meet the US execution requirement

- **Which Platforms Must Register as SEFs (CFTC Rules Part 37)?**
  - A SEF is a trading platform system or platform other than a DCM on which multiple participants have the ability to execute or trade swaps by accepting bids or offers made by multiple participants therein
  - The hallmark is the multiple-to-multiple (M-to-M) capability, regardless of how regularly used by the SEF's participants
  - Applies to all execution methodologies, including voice
  - <u>Geographic Scope</u>: any platform with users or participants that are US Persons (and likely eventually US-located persons)

Regulatory Landscape

SEFs vs. European Execution Venues

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	Swap Execution Facility (SEF)	Regulated Market (RM)	Multilateral Trading Facility (MTF)	Organised Trading Facility (OTF)
Interaction	Multilateral			
Access	Non-discriminatory, objective criteria – membership /agency access required	Non-discriminatory, objective criteria – membership required		Non-discriminatory, objective criteria – membership/ agency access not required
Execution	Non-Discretionary			Discretionary
Matched Principal	Permitted on a limited basis	Not permitted		Only for bond, structured finance, emission and certain derivative (unless subject to EMIR clearing) products
Pre-Trade Transparency	Encourage multiple bids/offers via order book bias, 15 sec. delay, 3:1 RFQ, RFQ participant access to order book resting bids and ongoing block threshold review	• Make public bids and offer depth of trading interest unless waiver applies • Calibrated for different types of trading systems		
Waivers	N/A	Pre-trade waivers for (i) orders “large in scale” and in order management systems, (ii) RFQ/voice systems above a size threshold (partial waiver-still show indicative bids/offers), (iii) derivatives not subject to trading obligation and other instruments that are not liquid		
Post Trade Transparency	Price and volume (among other data) published immediately – unless block trade delay or notional cap applicable	Price and volume to be published immediately – unless delay, volume cap or aggregation applicable		

SEF Registration
Product Scope and Implications

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- **FX Platforms Must Register as SEFs:**
  - ALL platforms that make any swaps available to trade must register as SEFs, regardless of whether the particular product is subject to the CFTC execution mandate
  - The CFTC's execution mandate is also limited to products that are defined as swaps
  - However, spot FX and deliverable FX swaps and forwards are not swaps
    - therefore platforms that only offer these products do not have to register as SEFs, and these products cannot be mandated to trade on SEF/DCM
  - A number of many-to-many FX platforms provisionally registered as SEFs in 2013

- **FX Prime Brokers (FXPBs) Are Not SEFs**
  - FXPBs don't operate as trading facilities, but instead offer credit intermediation allowing other counterparties (CPs) to trade with each other
  - FXPB composed of separate bilateral arrangements-no multiple-to-multiple interaction
  - FXPB not involved at point at which bids and offers interact and does not provide execution functionality, but instead steps in post-execution

- **What About Security-Based Swaps?**
  - SEC has proposed an analogous security-based swap execution facility (SBSEF) regime, but has not yet finalized its rules
  - Unclear what products will trigger platform registration and be subject to trading mandate

- **Implications of SEF Registration:**
  - SEF core principles apply; platform is subject to CFTC oversight
  - SEF is an SRO with a rulebook (applicable to all participants) and enforcement responsibilities
  - Minimum functionality (order book); minimum execution methods for "Required Transactions"
  - Other CFTC rules apply: confirmations; trade reporting; business conduct (unless anonymous or cleared); anti-disruptive practices ("violate bid/offer" only applies to cleared swaps executed through an order book and only on SEF-by-SEF basis)

The Rush to Implementation

What Gave Rise to SEF Challenges the Market Faces?

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- **Compressed Timeframe for Implementation:**
  - Market expected that SEF registration requirement would be phased in by product, with products first in line for clearing becoming subject to a trading mandate, and platforms making such products available to trade being required to register first
    - FX platforms were not expected to be captured in the initial waive of registration
  - However, final CFTC Rule Part 37 required all in-scope platforms to register in just 4-5 months (Oct. 2013), and the first trading mandates for rates and CDS followed only a few months later in Feb. 2014
    - All swap platforms, including FX platforms, were captured
  - Platform launches and conversions, as well as market participant implementation to ensure access to new SEF platforms, happened too rapidly for SEFs, market participants and regulators to solve many significant implementation problems

- **Uncertainty on Cross-Border Application:**
  - Although the CFTC had finalized its cross-border guidance as SEFs registered and the trading mandate approached, some cross-border issues remain unclear:
    - "Location of personnel test"-currently on-hold for non-US swap dealers; no detailed guidance
    - No substituted compliance for trading mandate and SEF registration and oversight requirements at this time
  - Non-US regimes have not implemented comparable requirements on the same timeframe
  - Impact → Following trading mandate effective date, global rates and CDS liquidity fragmented into SEF and non-SEF pools, which remains today

Implementation Challenges

Post-Implementation Developments and Debate

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- **High Volume of CFTC No-Action Relief ("NAL"):**
  - As a result of the compressed implementation timeline, SEFs and market participants did not have sufficient time to solve a number of key issues, requiring the CFTC to provide NALs to avoid market disruption
- **Key NALs:**
  - **Operational or Clerical Errors w/ Clearing SEF Trades (NAL 15-24):** SEFs and DCMs can submit a new trade to the clearinghouse on old terms, if the trade was rejected by the clearinghouse as the result of clerical or operational errors (not credit reasons) or if the trade was cleared and the errors were subsequently identified, subject to certain conditions
  - **Confirmations for Uncleared Trades (NAL 15-25):** Extended previous relief provided to SEFs from the requirement to obtain documents incorporated by reference in SEF confirmations for uncleared trades (e.g., ISDAs), subject to certain conditions (expires Mar. 31, 2016)
  - **Block Trade Occurs Away Requirements (NAL 14-118):** Suspends "occurs away" component of execution requirement under § 43.2 to allow SEFs to facilitate block trades using RFQ to 1 and other on-SEF execution methods. Pre-execution credit checks required when executing block trades using RFQ to 1 (expires Dec. 15, 2015)
  - **Package Transaction Execution Relief (NAL 14-137):** Relief from SEF execution of swap components that are part of a package transaction, building on a series of previous no-action letters (expiration of relief dependent on product type from May 2015-Feb. 2016)

Implementation Challenges

Post-Implementation Developments and Debate

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- **Commissioner Giancarlo's White Paper Recommendations:**
  - Swaps regulatory framework should be built upon five tenets: comprehensiveness, cohesiveness, flexibility, professionalism, and transparency.
  - Trade execution should be permitted through "any means of interstate commerce," and innovation should be encouraged in the swaps markets.
  - Impartial access does not mean that swaps trading venues have to provide "open access," therefore, requiring SEFs to serve every type of market participant or operate all-to-all marketplaces are unsupported by law.
  - Swaps market personnel should be held to higher professional standards, and subject to new standards of conduct or an examination program.
  - CFTC staff's *void ab initio* policy creates a competitive disadvantage for the US swaps market relative to the futures market.
  - CFTC's distinction between Required and Permitted Transactions arbitrary and unjustified.
  - Delays in transaction and pricing data disclosure caused by the embargo rule inhibit the work-up process, which increases wholesale trading liquidity in certain OTC swaps – hindering liquidity formation.
  - Because market liquidity is increasingly recognized as a potential systemic risk to the financial system, any regulatory action to curtail the use of name give-up must be thoroughly analyzed.
  - The CFTC's insistence on RFQ systems and centralized, order-driven markets to execute swaps could introduce algorithmic trading and high-frequency trading to the market, which is generally absent from the swaps market today.

Implementation Challenges
Issues and Proposed Solutions

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- **Confirm Requirements for Uncleared Swaps:**
  - Issue: SEFs required to obtain paper copies of privately-negotiated ISDA master agreements prior to execution of uncleared swaps
  - Solution: remove requirement as long as SEFs and CFTC have ability to request ISDAs on demand (CFTC currently has temporary no-action relief in place suspending requirement)

- **Clearing Certainty ("*Void ab Initio*"):**
  - Issues:
    - Tension between need for clearing certainty and need for counterparties to resubmit SEF trades rejected from clearing due to operational or clerical errors
  - Solution: allow SEF to resubmit original terms of a trade without SEF-mandated re-execution where trade has been cleared and operational or clerical error has been discovered (CFTC currently has temporary no-action relief in place imposing this solution)

- **Execution Methodology:**
  - Issue:
    - CFTC SEF rule restricts SEF execution for Required Transactions to order book or RFQ-to-3 despite no statutory requirement in Dodd-Frank to do so
  - Solution: allow CFTC to approve additional methods of execution for swaps that are "made available to trade", under certain circumstances

Implementation Challenges

Issues and Proposed Solutions

- **"Made Available to Trade" ("MAT") Determinations:**
  - Issue: current process to determine which products can be "made available to trade" on a SEF (and thus subject to the trading mandate) minimizes CFTC involvement, and does not treat the MAT determination as fluid based on changes to market conditions
  - Solution:
    - require SEFs to provide more granular explanation as to whether a swap contains sufficient trading liquidity for mandatory trading
    - Treat MAT determination as fluid by allowing SEFs and SEF users to remove a swap from a MAT determination if the trading characteristics of a product change such that it is no longer suited to be traded on SEF

- **Package Transactions:**
  - Issues:
    - if one leg of a package trade is subject to the trading requirement, then all legs must be executed on SEF via order book or RFQ to 3, even if liquidity is not sufficient to support
    - No current requirement that DCOs are able to net the risk of both legs at time of execution- because packages are currently cleared leg-by-leg, a DCO may reject an individual leg due to its risk exceeding its credit limit even though the net risk does not
  - Solution: (i) Require SEF to certify in rulebook that SEF can execute the complete package transaction, (ii) confirm that settlement of any non-swap leg is not adversely affected by execution of the package on SEF and (iii) require MAT determination to be made for package as a whole

Implementation Challenges

Issues and Proposed Solutions

- **SEF Financial Resources Requirements**
  - Issue:
    - CFTC rules require SEF to have sufficient resources to cover operating costs for at least 1 year
    - Some SEFs have brokers inside their SEF while others have brokers outside their SEF, so if broker compensation and benefits are included in the adequate resources test the "broker inside SEF" model will be at a competitive disadvantage
  - Solution:
    - SEFs should only be required to hold adequate resources to be able to wind down their operations in one year
    - Exclude compensation and benefits for brokers inside the SEF from being counted toward adequate resources so that both business models are treated evenly

- **Block Trade Pre-Trade Credit Limit Checks:**
  - Issues:
    - Requirement that block trades be executed away from the SEF platform creates an artificial and arbitrary division between non-block on-SEF and block off-SEF transactions
    - Extremely difficult for clearing members to perform pre-execution credit screening against FCM risk-based limits because FCM may have no involvement in block occurring away from SEF, even though CFTC clearing member risk management rules require clearing members to establish risk-based limits and to screen orders for compliance, and "straight through processing" rules requiring SEFs to coordinate with DCOs to ensure prompt and efficient processing by DCOs
  - Solution: Allow block trades to be executed on a SEF while preserving the CFTC's straight through processing requirements

FX Prime Brokerage
Execution Model and Benefits

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- **Pre-Dodd Frank FXPB Model**
  - Execution Methodology:
    - CP opens account with FXPB (directly or through agent) and FXPB grants CP limited agency to enter into FX on behalf of FXPB with approved executing dealers ("EDs") subject to pre-agreed limits
    - FXPB enters into "give up" arrangements with EDs designated by CP, under which EDs agree to execute ED-PB trades based upon agreement between ED and CP (as agent for FXPB)
    - CP selects economic terms quoted by ED on platform and, acting for FXPB, executes FX (the ED-PB trade) with the condition subsequent that the FXPB accept the trade outside the platform
    - If terms provided by FXPB and CP match and fall within pre-agreed parameters, FXPB must accept the trade
    - Off platform, when FXPB accepts the ED-PB trade, the FXPB also agrees to enter into a mirror image trade with the CP (the PB-CP trades)
    - FXPB confirms both the ED-PB and PB-CP trades, and reports the PB-CP trade
    - ED reports the ED-PB trade

  - Benefits to Liquidity:
    - FXPB credit intermediation enhances secondary market participation in multilateral platforms by enabling a CP to access pricing on a platform from multiple EDs who's liquidity may not otherwise be available to the counterparty
    - CPs benefit from increased price competition from multiple EDs on same platform while maintaining a single credit facility with their FXPB

FX Prime Brokerage

Issues and Proposed Solutions

- **Execution:**
  - CP is the SEF participant on behalf of the FXPB to negotiate and execute on the SEF with EDs
  - CP must identify the PB on whose behalf it is transacting to the SEF and ED, but can only identify PBs whose information is already available to the ED and SEF
  - In addition to terms of trade specified by SEF, each FXPB contract would have an additional condition subsequent that the PB accept the transaction

- **Post-Trade Processing:**
  - <u>Confirmations</u>:
    - SEF issues confirmation for ED-PB trade to CP and ED per CFTC rules; CP remains obligated to communicate terms of SEF confirm of ED-PB trade to PB
    - Will need to adjust confirm process to account for SEF confirms
  - <u>Reporting</u>:
    - SEF must report data for ED-PB trade to relevant swap data repository (SDR)
    - ED and PB will need to adjust reporting systems to suppress real time and SDR reporting of ED-PB trade

- **Off-SEF Events:**
  - <u>Notice to PB</u>: PB must receive notice of ED-PB trade post-execution on SEF from ED or CP to enable PB to match terms of transaction and determine if within limits
  - <u>Acceptance of ED-PB Trade</u>: if trade does not match and PB rejects, PB must notify ED and CP of rejection-ED responsible for reporting failure to satisfy condition precedent to relevant SDR as “continuation data” for relevant swap
  - <u>Mirror Image Trade</u>: if trade accepted, resulting mirror image trade between PB and CP would be off-facility-PB would confirm and report

FX Prime Brokerage
Issues and Proposed Solutions

- **Jurisdictional:**
  - Commodity Exchange Act requires each person with trading privileges on a SEF to be a SEF member, but CFTC guidance clarifies that “member” does not mean client or customer of a trading privilege holder that does not have direct trading access privileges
  - When CP acts as agent for PB, PB does not become obligated to become SEF member, and thus not subject to SEF jurisdiction except to same extent as a customer for whose benefit a trade is executed on SEF becomes subject to SEF jurisdiction

- **Solutions**
  - Further CFTC Clarification:
    - Most of the issues above have been raised to the CFTC and are subject to further resolution
  - SEF Model Rules:
    - Current SEF rulebooks do not operate as described above
    - Market participants have developed model rules to impose the process and solutions outlined above (draft rules are included in the materials)