

Three, Two, ~~One~~: The Regulatory Launch of Swaps Trading¹
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I. Introduction

On January 7, 2011 the Commodity Futures Trading Commission (Commission) proposed “Core Principles and Other Requirements for Swap Execution Facilities” (the SEF Proposal). Swap Execution Facilities (SEFs) are statutory creations of the Dodd-Frank Act that must be used to trade certain swaps. Two years and five months later, on June 4, 2013, the Commission finalized the SEF regulations (the Final SEF Rules).³

During the time between the SEF Proposal and the Final SEF Rules a great debate arose in the industry regarding the question of how many unaffiliated market participants must receive a request for quote for a swap subject to mandatory trade execution: Five, Four, Three, Two or One? This question overshadowed much of the substance of the SEF Proposal because any variation from the pre-Dodd-Frank mode of execution -- that is a bilaterally negotiated trade between a dealer and a customer -- would be a significant departure from incumbent market structure. The debate settled on two RFQ recipients initially, moving to three recipients beginning 14 months from the effective date of the Final SEF Rules, which is the end of September 2014. However, like many regulatory launches, the implementation, that is where the “RFQ meets the road,” has proved challenging and has resulted in guidance and no-action relief from Commission Staff.

With the majority of SEFs now provisionally registered and the first trade execution mandates in place, market participants must navigate a new trade execution environment. Not only are there choices for swaps, but traditional designated contract markets (DCMs) offer swaps and swap futures.

The following paper will explore the new trade execution environment that has been borne out of Dodd-Frank through providing an overview of the Final SEF Rules while highlighting some of the major differences with the SEF Proposal, summarizing recent no-action

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³ Core Principles and Other Requirements for Swap Execution Facilities, 78 Fed. Reg. 33,476 (June 4, 2013) (codified at 17 C.F.R. pt. 37).

relief, discussing recent market reaction to the new trade execution environment, and finally, providing some compliance-focused thoughts on how this environment will continue to evolve and interact in a self-regulatory and Commission enforcement-focused reality.

II. Phone Calls to Order Books: The Final SEF Rules

The Final SEF Rules set forth the SEF regulatory landscape, addressing the following key questions: Who must register as a SEF? What swaps are required to be transacted on a SEF or DCM? What functionality must a SEF offer? What are the requirements for swaps subject to the trading mandate versus those not? We answer each of these questions in turn.

A. *Who must register as a SEF?*

Swap Execution Facility is defined in Section 1a(50) of the Commodity Exchange Act (CEA) as follows:

a trading system or platform in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants in the facility or system, through any means of interstate commerce, including any trading facility, that—(A) facilitates the execution of swaps between persons; and (B) is not a designated contract market.⁴

The language the Commission included in the final rule describing which entities must register as a SEF is:

[a]ny person operating a facility that offers a trading system or platform in which 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 shall register the facility as a swap execution facility under this part 37 or as a designated contract market under part 38 of this chapter.⁵

The underlined language in both the CEA provision and the Final SEF Rule indicate that allowing multiple participants to execute swaps with multiple participants is a fundamental component of the SEF definition. However, many view the Commission's interpretation, which is "more than one" to be more inclusive than the CEA language. The Commission noted that the terms "trading system" and "platform" are not defined in the Dodd-Frank Act or anywhere in the CEA. However, the Commission stated that it will interpret "trading system" and "platform" to include, but not be limited to, the term "trading facility" as defined in Section 1a(51) of the CEA.⁶

⁴ Commodity Exchange Act, 7 U.S.C. § 1a(50).

⁵ 78 Fed. Reg. at 33,583.

⁶ The Definition of "Trading Facility" is:
(51) Trading facility

(continued...)

There seemed to be consensus in the industry that the requirement to register as a SEF would only be triggered for an execution facility offering swaps subject to the trading mandate.⁷ The Commission did not take this approach and, in fact, stated its intention to capture platforms and facilities offering swaps, regardless of whether those transactions are subject to the mandate in a footnote to the Final SEF Rules, the now infamous “Footnote 88,” which states, in relevant part:

The Commission notes that it is **not tying the registration requirement in CEA section 5h(a)(1) to the trade execution requirement in CEA section 2(h)(8)**, such that only facilities trading swaps subject to the trade execution requirement would be required to register as a SEF. **Therefore, a facility would be required to register as a SEF if it operates in a manner that meets**

(A) In general

The term “trading facility” means a person or group of persons that constitutes, maintains, or provides a physical or electronic facility or system in which multiple participants have the ability to execute or trade agreements, contracts, or transactions—

- (i) by accepting bids or offers made by other participants that are open to multiple participants in the facility or system; or
- (ii) through the interaction of multiple bids or multiple offers within a system with a pre-determined non-discretionary automated trade matching and execution algorithm.

(B) Exclusions

The term “trading facility” does not include—

- (i) a person or group of persons solely because the person or group of persons constitutes, maintains, or provides an electronic facility or system that enables participants to negotiate the terms of and enter into bilateral transactions as a result of communications exchanged by the parties and not from interaction of multiple bids and multiple offers within a predetermined, nondiscretionary automated trade matching and execution algorithm;
- (ii) a government securities dealer or government securities broker, to the extent that the dealer or broker executes or trades agreements, contracts, or transactions in government securities, or assists persons in communicating about, negotiating, entering into, executing, or trading an agreement, contract, or transaction in government securities (as the terms “government securities dealer”, “government securities broker”, and “government securities” are defined in section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a))); or
- (iii) facilities on which bids and offers, and acceptances of bids and offers effected on the facility, are not binding.

Any person, group of persons, dealer, broker, or facility described in clause (i) or (ii) is excluded from the meaning of the term “trading facility” for the purposes of this chapter without any prior specific approval, certification, or other action by the Commission.

(C) Special rule

A person or group of persons that would not otherwise constitute a trading facility shall not be considered to be a trading facility solely as a result of the submission to a derivatives clearing organization of transactions executed on or through the person or group of persons. Commodity Exchange Act, 7 U.S.C. § 1a(51).

⁷ Peter Madigan, *Risk USA: Footnote 88 prompts BlackRock to abandon NDF platforms*, Risk.net (Oct. 24, 2013), available at <http://www.risk.net/risk-magazine/news/2302680/risk-usa-footnote-88-prompts-blackrock-to-abandon-ndf-platforms>.

the SEF definition even though it only executes or trades swaps that are not subject to the trade execution mandate. The Commission also notes that transactions involving swaps on SEFs that are subject to the trade execution mandate are considered to be “Required Transactions” under part 37 of the Commission’s regulations, whereas “Permitted Transactions” are transactions not involving swaps that are subject to the trade execution mandate.⁸

There is ongoing debate around exactly which entities are required to register as SEFs, based on the definition of a “SEF” above. Although Congress’ intent appeared to be to capture exchanges like exist in the futures and securities markets for illiquid swaps, the language is subject to broader interpretation as the Commission has recognized.⁹ The Commission stated in the final rule that “all of the relevant facts and circumstances of the entity’s operations” must be analyzed to determine whether an entity falls within the scope of the SEF registration requirement.¹⁰ The recognition of the importance of the relevant facts and circumstances is necessary because, as the Commission noted, “although the registration provision is written in broad language and could be read to require the registration of any facility for the trading or processing of swaps, the Commission notes that other statutory provisions appear to narrow the registration requirement.”¹¹

Despite the recognition that the language may be read as overly broad, there has been concern regarding the entities that the Commission believes should be considered SEFs. There remain outstanding registration questions in this area, some of which may be answered as the anticipated Chairman of the Commission, Timothy Massad, is confirmed as the next Chairman of the Commission.

B. What swaps are required to be transacted on a SEF or DCM?

The same day as the Commission finalized the Final SEF Rules, it also finalized the rule setting forth the process to make a swap “available to trade.” That phrase is adapted from language in the Dodd-Frank Act, but the Commission took it upon themselves to create a process to make particular transactions available to trade.

A SEF or DCM may obtain a “made available to trade” determination for a swap that it lists or offers for trading that is subject to the clearing mandate via one of two processes: self-certification or approval.¹² The SEF or DCM must consider one or more of a list of

⁸ 78 Fed. Reg. at 33,481.

⁹ H.R. Rep. No. 112-345, at 2 (2011-2012) (discussing the purpose of the Swap Execution Facility Clarification Act, H.R. 2586, 112th Cong. (2012)).

¹⁰ 78 Fed. Reg. at 33,482.

¹¹ *Id.* at 33,481.

¹² For affirmative Commission approval, the SEF or DCM submits a rule, which is subject to a 45-day review period by the Commission. The Commission may approve, disapprove, or stay the rule for another 45 days of review. Any additional review beyond the two 45-day periods requires SEF or DCM consent. At any time during the review, the Commission may notify the SEF or DCM that the rule is disapproved. Absent Commission action, the rule becomes effective after the review period expires. 17 C.F.R. § 40.5. The alternative to the approval process (continued...)

enumerated factors, all of which target liquidity in preparing its submissions.¹³ Once a swap is made available to trade, 30 days later the swap can only be transacted by non-exempt persons (e.g. non end-users, non-affiliates) on or subject to the rules of a SEF or DCM and may only be executed via permitted execution methods, as discussed below.

Made available to trade determinations have been accepted for some interest rate swaps and some credit default swaps.¹⁴ In the future the Commission will accept submissions from SEFs as to which particular swaps in other asset classes should be subject to mandatory trading, with non-deliverable forwards likely coming next following the clearing mandate.

On May 1, 2014, the Commission issued time-limited no-action relief for market participants from the mandatory execution of package transactions on a SEF or DCM.¹⁵ Beginning May 16, 2014, market participants executing swaps that are subject to the trade execution requirement that are part of a “package transaction” must be traded on a SEF or DCM. A package transaction is a transaction involving two or more instruments:

- (1) that is executed between two or more counterparties;
- (2) that is priced or quoted as one economic transaction with simultaneous or near simultaneous execution of all components;
- (3) that has at least one component that is a swap that is made available to trade and therefore is subject to the CEA section 2(h)(8)

is the self-certification process. A SEF or DCM may self-certify a rule saying that a swap is MAT, and the Commission has 10 days to disapprove or stay the rule. If no action is taken, the rule becomes effective. The stay is up to 90 days, which includes a 30-day public comment period and, absent Commission action, the rule is approved. At any time during the 90-day review, the Commission may notify the SEF or DCM of an objection to the rule. 17 C.F.R. § 40.6.

¹³ The final rule provides:

Final §§ 37.10(b) and 38.12(b) require a SEF or DCM to consider, as appropriate, six factors with respect to each swap when determining whether a swap is available to trade: (1) Whether there are ready and willing buyers and sellers; (2) the frequency or size of transactions; (3) the trading volume; (4) the number and types of market participants; (5) the bid/ask spread; or (6) the usual number of resting firm or indicative bids and offers. No single factor must always be considered as to whether a swap is available to trade; therefore, the SEF or DCM may consider any one or more of the factors in its initial determination. In its submission to the Commission under § 37.10(a) or § 38.12(a), a SEF or DCM must describe how it considered the factors that it deems appropriate.

78 Fed. Reg. at 33,620.

¹⁴ Press Release, CFTC Office of Pub. Affairs, The Commodity Futures Trading Commission Staff Announces Trade Execution Mandate for Certain Interest Rate Swaps (Jan. 16, 2014), <http://www.cftc.gov/PressRoom/PressReleases/pr6831-14>; Press Release, CFTC Office of Pub. Affairs, The Commodity Futures Trading Commission’s Division of Market Oversight Announces Trade Execution Mandate for Certain Credit Default Swaps and Additional Interest Rate Swaps (Jan. 28, 2014), <http://www.cftc.gov/PressRoom/PressReleases/pr6841-14>.

¹⁵ No-Action Relief from the Commodity Exchange Act Sections 2(h)(8) and 5(d)(9) and from Commission Regulation § 37.9 for Swaps Executed as Part of Certain Package Transactions and No-Action Relief for Swap Execution Facilities from Compliance with Certain Requirements of Commission Regulations § 37.9(a)(2), § 37.203(a) and § 38.152 for Package Transactions, Commission No-Action Letter 14-62 (May 1, 2014), <http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/14-62.pdf>.

trade execution requirement; and (4) where the execution of each component is contingent upon the execution of all other components.¹⁶

The relief is phased-in as follows:

- For package transactions in which all components are swap subject to the trade execution requirement, there is no additional relief, so compliance is required May 16, 2014.
- For package transactions in which the components include at least one swap component that is subject to the trade execution requirement and all other components are swaps subject to the mandatory clearing requirement, relief is provided until June 2, 2014.
- For package transactions in which the swap components are subject to the trade execution requirement and all other components are U.S. Treasury securities (U.S. Dollar Swap Spreads), relief is provided until June 16, 2014.
- For package transactions (excluding U.S. Dollar Swap Spreads) in which the components include at least one swap component that is subject to the trade execution requirement and at least one component that is not a swap, relief is provided until November 16, 2014.
- For package transactions in which the components include at least one swap component that is subject to the trade execution requirement and at least one swap component that is under the Commission’s exclusive jurisdiction and not subject to the clearing requirement, relief is provided until November 16, 2014.
- For package transactions in which the components include at least one swap component that is subject to the trade execution requirement and at least one swap component that is a swap over which the Commission does not have exclusive jurisdiction, relief is provided until November 16, 2014.

C. What functionality must a SEF offer?

Once an entity is determined to be a SEF, the next question is what functionality a SEF must provide. The only functionality SEFs are required to provide is an order book.¹⁷ The order book must be provided for both required transactions and permitted transactions.¹⁸

¹⁶ *Id.*

¹⁷ 78 Fed. Reg. at 33,583.

¹⁸ *Id.*

However, the order book is not required to be electronic.¹⁹ Moreover, if an order book uses a matching algorithm, the algorithm does not even need to match best bid/best offer; the algorithm need only be disclosed in the SEF rulebook and submitted to the Commission for review and approval as part of the registration application.²⁰

D. What are the requirements for swaps that are subject to the trading mandate versus those not?

In terms of execution, required transactions and permitted transactions are treated differently. Required transactions may be executed in the order book (including via cross-trade), through RFQ, or in a block trade, all of which are discussed below.²¹ Permitted transactions may be executed in the order book, RFQ, block trade, or any other means of interstate commerce, including by voice.²² Moreover, the Commission included in the rule preamble language that allows a SEF to petition the Commission to amend its regulations to include additional execution methods for required transactions, but at this point that has not occurred.²³

Cross-Trades: Should a broker or dealer want to execute against its customer's order or execute two of its customers' orders against each other through the order book following some form of pre-arrangement, the SEF must require one side of the trade to be shown to the market for at least 15 seconds before execution of the transaction.²⁴

RFQ: A SEF does not have to offer an RFQ, but, if it is allowing required transactions to be executed via RFQ, participants on the trading system must transmit an RFQ to buy or sell a specific instrument to no less than two unaffiliated market participants, to which the recipients may respond.²⁵ At the end of September 2014, the number of required recipients will increase to three.²⁶ Additionally, the SEF must provide the requester with the firm resting bids or offers in the order book and give the requester the ability to execute against those as well as responsive orders.²⁷

Swap Blocks: Swap block thresholds are set forth in the swap block rule, which was also finalized the day the Commission finalized the SEF rules. The block thresholds for interest rate swaps and credit default swaps are currently set using a 50% notional amount

¹⁹ “An order book may be an electronic trading facility, a trading facility, or ‘a trading system or platform in which all market participants in the trading system or platform have the ability to enter multiple bids and offers, observe or receive bids and offers entered by other market participants, and transact on such bids and offers.’” *Id.* Compare to the industry standard CME Globex algorithm, which provides several matching algorithms, including first-in first-out. CME Group (Apr. 8, 2014), <http://www.cmegroup.com/confluence/display/EPICSANDBOX/Matching+Algorithms>.

²⁰ 78 Fed. Reg. at 33,583.

²¹ *Id.* at 33,586.

²² *Id.*

²³ *Id.* at 33,501.

²⁴ *Id.* at 33,586.

²⁵ *Id.*

²⁶ *Id.* at 33,476.

²⁷ *Id.* at 33,586.

calculation, which means that 50% of the notional amount of the swap is in blocks and 50% is not.²⁸ For other asset classes (foreign exchange swaps and other commodity swaps) the block thresholds are currently set based on the DCM block sizes for economically related futures contracts, if available.²⁹ [The variation is due to data availability.] Per the rule, the percentage will change to 67%, meaning only 33% will be in blocks, after at least one year of reliable data.³⁰ However, based on recent issues concerning data provision, sufficiency, and usability, the Commission is not likely to make that adjustment in the near future.³¹ The block thresholds will be recalculated with new data, but still at the 67% level, at least every year thereafter.³²

III. Jurisdiction, Operational Errors, and Open Access: Commission Staff Guidance and No-Action Relief

In the process of moving swap trading onto SEFs there have been several hiccups, which have spurred staff to issue no-action relief. This section discusses some of the key events that have brought us to where we are today.

A. *SEFs without rules?*

The Final SEF Rules set forth the registration process, which included a “temporary registration” stage. That process essentially allowed for approval upon application as the only requirement was that the application be complete on its face.³³ Today, SEFs are still temporarily registered and will not be fully registered for approximately two more years.³⁴ That cursory review process allowed SEFs with rulebooks that could potentially be viewed as non-compliant with the SEF Core Principles to begin operating.³⁵

As the October 2, 2013 deadline for entities meeting the SEF definition to register approached, there was general confusion, even panic, in the market because of the uncertainty around these SEF rulebooks, which were long, constantly changing, and, in some cases,

²⁸ 78 Fed. Reg. 32,866, 32,939 (May 31, 2013).

²⁹ *Id.*

³⁰ *Id.* at 32,893.

³¹ Proposed Rule, Review of Swap Data Recordkeeping and Reporting Requirements, 79 Fed. Reg. 16,689 (Mar. 26, 2014).

³² 78 Fed. Reg. at 33,586.

³³ *Id.* at 33,583-34.

³⁴ *Id.* at 33,584.

³⁵ Division of Market Oversight Guidance on Application of Certain Commission Regulations to Swap Execution Facilities (Sept. 30, 2013),

http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/dmo_staffguidance093013.pdf (“[I]t has come to the Division’s attention that some SEF rulebooks contain provisions which appear to be inconsistent with the Commission’s regulations,” adding “the Division notes that it did not undertake a substantive review of the SEF’s rulebooks during the temporary registration process.”); Matthew Leising, *Gensler Says Three Swap Market Operators Must Tweak Access Rules*, Bloomberg (Nov. 18, 2013), available at

<http://www.bloomberg.com/news/2013-11-18/gensler-says-three-swap-market-operators-must-tweak-access-rules.html>.

incomplete.³⁶ The Commission issued no-action relief that allowed SEFs to onboard customers without subjecting them to its jurisdiction, delaying the requirement that customers sign SEF user agreements, and allowing existing workflows to continue until November 1, 2013.³⁷ That relief expired and customers began having to sign up to SEFs in order to trade swaps on a multiple-to-multiple facility. Shortly thereafter, the Commission issued guidance reiterating that any criteria for an Eligible Contract Participant (ECP) to access a SEF must be “impartial, transparent, and applied in a fair and non-discriminatory matter” in order to open discriminatory platforms to the public.³⁸

The guidance expressly prohibited the use of “enablement mechanisms,” which it defined as “any mechanism, scheme, functionality, counterparty filter, or other arrangement that prevents a market participant from interacting or trading with, or viewing the bids and offers (firm or indicative) displayed by any other market participant on that SEF.”³⁹ In addition, the guidance specifically stated that intermediated access, otherwise known as “agency access,” is a permissible means of accessing SEFs because it comports with the requirement that SEFs allow impartial access.⁴⁰ Agency access permits market participants to connect to a SEF indirectly through an agent, which allows customers to avoid signing up to multiple hundred-plus-page rulebooks and only requires customers to consent to SEF jurisdiction.

B. *Straight-through-processing*

Shortly before the October 2nd SEF onboarding “panic,” Staff in the Divisions of Market Oversight and Clearing and Risk issued guidance regarding the Commission’s expectations for straight-through-processing.⁴¹ The guidance stated that all orders on SEFs and DCMs must be pre-screened against credit limits and, more importantly, it shortened the window in which a DCO must accept or reject a trade based on the futures commission merchant’s (FCM’s) credit limits at the DCO from 60 seconds to 10 seconds.⁴² Any trade not accepted within 10 seconds the Staff declared to be void *ab initio*.⁴³ As a result, the Staff stated its view that breakage agreements are not necessary and, moreover, they are an impediment to impartial

³⁶ Katy Burne and Geoffrey T. Smith, *Swaps Rules Worry Industry*, The Wall Street Journal (Sept. 26, 2013), <http://online.wsj.com/news/articles/SB1000142405270230479580457909916030144206>.

³⁷ Time-Limited No-Action Relief for Temporarily Registered Swap Execution Facilities from Enforcement Responsibilities Under Commission Regulations 37.200(a), 37.200(b), 37.201(b)(1), 37.201(b)(3), 37.201 (b)(5), 37.202(b), and 37.203, Commission No-Action Letter 13-57 (Sept. 27, 2013), <http://www.cftc.gov/ucm/groups/public/lrlettergeneral/documents/letter/13-57.pdf>.

³⁸ 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, Commission Guidance (Nov. 14, 2013), <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/dmostaffguidance111413.pdf>.

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ Staff Guidance on Swaps Straight-Through Processing, Commission (Sept. 26, 2013), <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/stpguidance.pdf>.

⁴² *Id.*

⁴³ *Id.*

access on SEFs.⁴⁴ Therefore, Staff prohibited DCMs, SEFs, FCMs, and swap dealers from requiring breakage agreements as a condition to access a SEF or DCM.⁴⁵

On October 25, 2013, the Commission provided related relief until June 30, 2014, which allows for re-execution of a swap that fails to clear for operational reasons, but still labeled trades rejected for clearing for credit reasons as void *ab initio*.⁴⁶ To re-execute the swap, the incident must be reported and the counterparties and their clearing members must agree to re-execute.⁴⁷

C. *New changes to old recording requirement*

In February 2012, the Commission amended Regulation 1.35, which sets forth requirements to retain written communications and record and retain oral communications, to apply to members of SEFs as it applies to members of DCMs.⁴⁸ The rule requires recordings of all conversations that lead to a transaction of a commodity interest (future, swap, retail FX, or option), but exempts certain participants from the requirement to record oral communications.⁴⁹ Exempt participants include CPOs and members of a DCM or SEF that are not registered or required to be registered with the Commission in any capacity.⁵⁰ There have been extensive questions regarding what communications are considered to “lead to” a transaction, why the written recordkeeping includes everything from text messages to instant messages, and what the Commission’s reasoning was when deciding which entities to exempt from the oral recordkeeping requirement. In light of the difficulty of the transition to executing swaps on SEFs and market participants’ resistance to recording under Regulation 1.35, which some contend is impossible, the Commission issued no-action relief from the oral recording requirement for commodity trading advisors trading on SEFs until May 1, 2014.⁵¹ In order to treat DCMs executing swaps and SEFs the same, the Commission issued corresponding no-action relief for commodity trading advisors trading swaps on DCMs.⁵² Despite the parity of

⁴⁴ *Id.*

⁴⁵ *Id.* Also in the guidance, the Staff highlighted that there are no breakage agreements in futures, which further demonstrates that they are not necessary in swaps. *Id.*

⁴⁶ Time-Limited No-Action Relief for Swap Execution Facilities from Compliance with Certain Requirements of Commission Regulation 37.9(a)(2) and 27.203(a), Commission No-Action Letter No. 13-66 (Oct. 25, 2013), <http://www.cftc.gov/ucm/groups/public/@lrllettergeneral/documents/letter/13-66.pdf>.

⁴⁷ *Id.*

⁴⁸ Adaptation of Regulations to Incorporate Swaps - Records of Transactions, 77 Fed. Reg. 75,523 (Dec. 21, 2012).

⁴⁹ *Id.* at 75,541-42.

⁵⁰ *Id.* at 75,542.

⁵¹ Time-Limited No-Action Relief for Certain members of Swap Execution Facilities from the Requirement to Record Oral Communications Pursuant to Commission Regulation 1.35(a) (Dec. 20, 2013), <http://www.cftc.gov/ucm/groups/public/@lrllettergeneral/documents/letter/13-77.pdf>.

⁵² Time-Limited No-Action Relief for Certain Members of a Designated Contract Market from the Requirement to Record Oral Communications, Pursuant to Commission Regulation 1.35(a), in Connection with the Execution of Swap Transactions (Mar. 21, 2014), <http://www.cftc.gov/ucm/groups/public/@lrllettergeneral/documents/letter/14-33.pdf>.

treatment of SEFs and DCMs for purposes of executing swaps, market participants continue to grapple with the compliance cost and burden of Regulation 1.35.⁵³

D. Are European exchanges SEFs too?

On February 12, 2014, the Commission issued relief for Multilateral Trading Facilities (MTFs) to allow those overseen by “competent authorities designated by the European Union Member States” to continue to operate without registering as SEFs.⁵⁴ The same letter provides relief from the requirement that parties subject to the trading mandate execute swaps on a SEF or DCM for parties executing swaps on MTFs.⁵⁵ The relief expired March 24, 2014, and the Commission issued a follow-on relief letter allowing only those MTFs that submitted relief requests and were approved to continue to use the relief.⁵⁶

IV. SEF Alternatives: DCMs and Futurization

A year prior to the finalization of the SEF rules, in October 2012, the “swap” definition went into effect which defined the products that trigger swap dealer registration and are subject to reporting obligations. Given uncertainty in the industry due to how these new swap rules would impact market participants, several actions were taken by various market participants to limit the reach of the new swap rules. Specifically, in October 2012, leading futures exchanges took several steps to transition significant elements of the energy swap business to energy futures. More specifically, on October 15, 2012, ICE Futures OTC Markets transitioned all cleared OTC energy swaps to futures and options contracts,⁵⁷ and ICE Futures U.S. lowered its block trade size to permit bilateral execution of energy futures.⁵⁸ On the same date, CME Group transitioned the CME ClearPort business model to promote direct execution of CME ClearPort energy futures contracts by means of trading on CME Globex (*i.e.*, order book) and on the trading floor,⁵⁹ and also made amendments to its block trade sizes. These changes, termed “futurization” of swaps, have resulted in extensive coverage in the media and have been

⁵³ CFTC Dodd-Frank End-User Issues Roundtable (Apr. 3, 2014), http://www.cftc.gov/press/roomevents/rt_040314agenda (noting the first panel of the end-user roundtable was a discussion of Regulation 1.35).

⁵⁴ Time-Limited No-Action Relief with Respect to Swaps Trading on Certain Multilateral Trading Facilities Overseen by Competent Authorities Designated by European Union Member States, CFTC No-Action Letter No. 14-15 (Feb. 12, 2014), <http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/14-15.pdf>.

⁵⁵ *Id.*

⁵⁶ Extension of Time-Limited No-Action Relief with Respect to Swaps Trading on Certain Multilateral Trading Facilities Overseen by Competent Authorities Designated by European Union Member States, CFTC No-Action Letter No. 14-31 (Mar. 21, 2014), <http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/14-31.pdf>.

⁵⁷ See ICE OTC Advisory, ICE OTC Markets – Energy Contracts to be subject to ICE Futures U.S. and ICE Futures Europe Rulebooks (Oct. 12, 2012), https://www.theice.com/publicdocs/otc/advisory_notices/ICE_Advisory_10_12_003.pdf.

⁵⁸ *Id.*

⁵⁹ See CME Group Issues a Market Regulation Advisory Notice for CME ClearPort (Oct. 12, 2012), <http://cmegroup.mediaroom.com/2012-10-12-CME-Group-Issues-a-Market-Regulation-Advisory-Notice-for-CME-ClearPort?pagetemplate=article>.

discussed in a Congressional hearing⁶⁰ and at a Commission Roundtable, as views on the matter vary greatly.⁶¹

In addition, CME Group and Eris Exchange have offered their customers “futurized” interest rate swaps, which have also drawn scrutiny and praise.⁶² Specifically, CME Group offers a deliverable interest rate swap futures contract. The product is traded as a future in CME Group’s central limit order book and, if not offset, the contract settles through the delivery of an interest rate swap.⁶³

Eris Exchange, which was founded in 2010 just prior to the finalization of Dodd-Frank, was designated as a contract market to trade interest rate swap futures contracts on October 29, 2011. Eris Exchange’s interest rate swap futures product, which can only be traded on Eris Exchange, provides a “[u]nique contract design [that] replicates OTC Swap economics.”⁶⁴ Eris Exchange states that its product offers a “futures product solution to Dodd-Frank requirements,” as well as curve trading, invoice spreads, and margin offsets with CME Group futures.⁶⁵

Some industry participants, as well as Commissioner O’Malia, have claimed that “futurization” is a natural evolution of the markets and is a response to the uncertainty and increased costs (a term that has been coined “regulatory overhead”) of the Dodd-Frank Act,⁶⁶

⁶⁰ See Hearing entitled *Challenges Facing the U.S. Capital Markets to Effectively Implement Title VII of the Dodd-Frank Act*, Subcommittee on Capital Markets and Government Sponsored Enterprises of the Committee on Financial Services (Dec. 12, 2012), <http://financialservices.house.gov/calendar/eventsingle.aspx?EventID=314629>.

⁶¹ See CFTC Staff to Host Public Roundtable to Discuss the *Futurization of Swaps* (Jan. 31, 2013), http://www.cftc.gov/PressRoom/Events/opaevent_cftcstaff013113; Transcript of Commodity Futures Trading Commission Public Roundtable on Futurization of Swaps (Jan. 31, 2013), http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission13_013113-trans.pdf (the “Transcript”). For example, ICE Futures U.S. testified that they transitioned their energy swaps to energy futures because it “was the natural evolution of these markets from purely OTC to . . . fully regulated futures.” Transcript at 37:22-38:2.

⁶² See, e.g., CME Group 2-Year Deliverable Interest Rate Swap Futures, <http://www.cmegroup.com/trading/interest-rates/deliverable-swaps/2-year-deliverable-interest-rate-swap-futures-contract-specifications.html> (last visited May 29, 2013) ; Eris Exchange Interest Rate Swap Futures Standard Contract, <http://www.erisfutures.com/2-yr-eris-standard-contract-specifications> (last visited May 29, 2013) Transcript at 37:6-15; 55:14-22; 56:18-57:1; 132:9-10; 136:12-20; 160:13-21; Robert Litan, *Futurization of Swaps: A Clever Innovation Raises Novel Policy Issues for Regulators*, Bloomberg Government (Jan. 14, 2013); Darrell Duffie, *Futurization of Swaps: Stanford’s Duffie Offers Another Viewpoint on This Emerging Trend*, Bloomberg Government (Jan. 28, 2013).

⁶³ CME Group (Apr. 7, 2014, 7:55 PM), <http://www.cmegroup.com/trading/interest-rates/files/dsf-overview.pdf>.

⁶⁴ Eris Exchange, Eris Swap Futures (Apr. 9, 2014 6:14 PM), http://www.erisfutures.com/EE/Eris_Swap_Futures_Overview.pdf.

⁶⁵ *Id.*

⁶⁶ Transcript at 132:9-10; Commissioner Scott O’Malia stated in a recent speech:

As you well know, Commission swap rules have introduced unnecessary complexity and generated additional costs in running a business. As a result, market participants (and for good reason), have been (continued...)

while others have argued that “futurization” amounts to regulatory avoidance of the Dodd-Frank Act.⁶⁷ Although futures have long been considered a highly regulated financial product, the burden imposed under the swaps regulatory regime established by the Dodd-Frank Act is different and arguably results in higher regulatory costs for users due to the registration, business conduct, capital, and margin requirements that are applied to those trading swaps. Specifically, there is a significant difference in the margin treatment between interest rate futures (which can be margined as low as one-day value at risk (VaR)) and interest rate swaps (which, absent Commission order, must be margined at no less than five-day VaR). Bloomberg L.P. unsuccessfully brought a lawsuit against the Commission alleging that the difference in margin treatment violated the Administrative Procedures Act because the Commission’s “disparate [margin] treatment of futures and commodity-based swaps, on the one hand, and financial swaps, on the other hand, has improperly created an opportunity for arbitrage between financial swaps and interchangeable ‘swap futures’ contracts.”⁶⁸ While this lawsuit was unsuccessful, it is clear that a market evolution is underway in terms of products—swaps versus swap futures. This evolution provides end-users with a choice to use swaps that are subject to a new regulatory regime or to continue to use futures which are subject to a known and well-established regulatory regime. Naturally, there are benefits and drawbacks to each product type.

While “futurization” relates to using futures rather than swaps, one execution venue has registered with the Commission to offer swaps on both the traditional DCM and on a SEF: trueEX, LLC (trueEX).⁶⁹ trueEX was launched in 2011 and became registered as a DCM on September 25, 2012. On September 20, 2013, trueEX was temporarily registered as a SEF. trueEX’s DCM offers a central limit order book and trueEX’s SEF offers the RFQ trading protocol (and SEF order book), both for interest rate swaps. trueEX also offers a proprietary portfolio terminations and compactions system for trade management of existing positions and a post-trade services platform to facilitate the processing requirements associated with the recently enacted regulations and no-action letters.⁷⁰

quick to convert swaps to futures and move their business to the futures markets. Futures exchanges offer clear rules and the efficiency of a one-day margining regime.

Commissioner Scott O’Malia, Keynote Address “New Risk in Energy 2014: Energy Trading Risk and the Policy that Drives It; If It’s Worth Fixing, It’s Worth Fixing It Right” (Apr. 7, 2014), <http://www.cftc.gov/PressRoom/SpeechesTestimony/opaomalia-35>.

⁶⁷ Transcript at 55:14-22.

⁶⁸ *Bloomberg LP v. U.S. Commodity Futures Trading Comm’n*, 13-cv-00523 (D.D.C. filed Apr. 16, 2013), Complaint at p. 1, *dismissed* (June 7, 2013).

⁶⁹ CFTC, List of Registered DCMs (Apr. 9, 2014 8:45 AM), <http://sirt.cftc.gov/SIRT/SIRT.aspx?Topic=TradingOrganizations&implicit=true&type=DCM&CustomColumnDisplay=TTTTTTTT>; CFTC, List of Temporarily Registered SEFs (Apr. 9, 2014 8:47 AM), <http://sirt.cftc.gov/SIRT/SIRT.aspx?Topic=SwapExecutionFacilities>. GFI is also dually registered, but their DCM application is still pending. GFI filed for a DCM given how long SEF rule finalization was taking. See *supra* List of Registered DCMs and List of Temporarily Registered SEFs.

⁷⁰ Customer Clearing Documentation, Timing of Acceptance for Clearing, and Clearing Member Risk Management, 77 Fed. Reg. 21,278 (Apr. 9, 2012); Alternative Compliance Schedule for Regulation 1.74 - Timing of Acceptance of Trades for Clearing (Oct. 26, 2012), *available at* (continued...)

V. Market Reaction: Swap Traction?

A. *The SEF landscape*

As of April 4, 2014, there were twenty-four (24) SEFs temporarily registered with the Commission.⁷¹ While the SEFs have been temporarily registered Commission, they still must all undergo a detailed review by the Commission.⁷²

Despite the delay, until there are fully registered SEFs as the temporarily registered SEFS await a detailed review by the Staff of the Commission, the overall market structure of how SEFs will be used is coming into view. At this point many market participants have signed up directly with one or more SEFs to trade on those specific SEFs. However, given that there are at least 24 SEFs, some market participants have looked for a single entry point to the various liquidity pools available on SEFs. Therefore, market participants have signed up with one introducing broker in order to access multiple SEFs, on an agency basis.⁷³ Given this set-up, it is possible to access to multiple SEFs through one connection as opposed to 24.

As noted above, once the “clearing mandate” is established for a class of swaps, the swaps within that class are eligible to become subject to mandatory trading. Once a swap that is subject to the clearing mandate is determined to be subject to the trading mandate, it must be traded on either a DCM (*i.e.*, trueEX) or a SEF.⁷⁴ On February 15, 2014, the trade execution mandate commenced for certain interest rate swaps.⁷⁵ On February 26, 2014, the trade execution mandate commenced for certain credit default swaps.⁷⁶ Cleared swaps not made available to trade and uncleared swaps may still be traded bilaterally or on a single-dealer platform.⁷⁷ With the commencement of the registration of SEFs and the trading mandate, the question is how much trading will take place on SEFs?

<http://www.cftc.gov/ucm/groups/public/@requestsandactions/documents/ifdocs/complschedtmgrdclrg-ubs.pdf>; Staff Guidance on Swaps Straight-Through Processing, Commission (Sept. 26, 2013), <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/stpguidance.pdf>; Will Rhode, TABB Group, *Swap Terminator: A Central Clearing Solution* (Oct. 2013), https://www.trueex.com/assets/TABB_swap_terminator.pdf. Cite CFTC rules on STP - including Section 37 and 38 for SEFs and DCMs.

⁷¹ List of Temporarily Registered SEFs, *supra* note 69.

⁷² 78 Fed. Reg. at 33,583-34.

⁷³ UBS (Apr. 7, 2014, 8:00 PM), <http://www.ubs.com/microsites/about-neo/home/>.

⁷⁴ Commodity Exchange Act, 7 U.S.C. § 2(h)(8) of the CEA (generally referred to as the “trade execution requirement”).

⁷⁵ Press Release, CFTC Office of Pub. Affairs, The Commodity Futures Trading Commission Staff Announces Trade Execution Mandate for Certain Interest Rate Swaps (Jan. 16, 2014), <http://www.cftc.gov/PressRoom/PressReleases/pr6831-14>.

⁷⁶ Press Release, CFTC Office of Pub. Affairs, The Commodity Futures Trading Commission’s Division of Market Oversight Announces Trade Execution Mandate for Certain Credit Default Swaps and Additional Interest Rate Swaps (Jan. 28, 2014), <http://www.cftc.gov/PressRoom/PressReleases/pr6841-14>.

⁷⁷ The Dodd-Frank Act contains broad anti-avoidance language that, in effect, prohibits market participants from adjusting the terms of a trade solely to prevent the terms from matching the criteria of products available to trade.

B. *SEF trading volumes are increasing*

Recent market analysis has shown that trading on SEFs is increasing. Indeed, at the time of the publication of this article, week five of the trading mandate saw the largest increase in volume to date. For example, \$317 billion in notional value of plain vanilla dollar denominated interest rate swaps traded on ten SEFs during the week ending March 21, 2014.⁷⁸ Out of this \$317 billion, 98% was traded on six of these ten SEFs. Other third party sources have also indicated that SEF notional amounts have grown steadily, rising 28% since October 2013 with SEF trading representing roughly 40% of total rates notional amounts as of January 2014.⁷⁹ Overall, the Commission weekly swaps report shows that during the week ending March 14, 2014 total transaction dollar volume in all interest rate swaps was \$3.8 trillion.⁸⁰

Not surprisingly, additional market research is needed to determine why some SEFs have more volume than others and which large financial institutions are supporting particular SEFs. In addition, in a world where the technology of an RFQ is straightforward, SEF success will largely be determined by the technology offered and, more importantly, the liquidity that supports the SEF. That is to say every SEF should ask: What large financial institutions are supporting and trading on the platform? While a market participant can get into or out of a swap on any SEF, favorites and market leaders may emerge.

Notwithstanding the benefits of volume, as trading volumes increase, it is a natural result that the potential for market misconduct will also increase. This is where the RFQ meets the road, which is policed by both the SEFs themselves and the Commission.

VI. Self-Regulation and Commission Regulation

SEFs are self-regulatory organizations, meaning they are charged with complying with “core principles,” which specifically includes market surveillance. Market participants are subject to investigation by a SEF for activities such as wash trading and market manipulation. A SEF can bring disciplinary action against market participants for rulebook violations and such action may result in expulsion from the SEF. Given the natural tension that exists between a marketplace attempting to compete and gain market share and the self-regulatory obligations, it remains to be seen how aggressively SEFs will police their markets. In addition, the Commission will have a prominent role in shaping the market structure through rule enforcement review and general compliance “spot-checks.” The regulatory structure for SEFs, while similar

⁷⁸ TABB Forum, *SEF MAT Week 5 Volumes Hit Record and a New SEF is on Top* (Mar. 30, 2014), <http://www.tabbforum.com/opinions/sef-mat-week-5-volumes-hit-record-and-a-new-sef-is-on-top?page=2>. Based on the readily available public data and through secondary sources, it is not clear the breakdown between on SEF trades and block trades facilitated pursuant to a SEF rulebook.

⁷⁹ ISDA, SwapsInfo (Feb. 6, 2014), <http://www.swapsinfo.org/monthly-market-commentary/2014/02/swapsinfo-monthly-market-analysis-february-2014/>.

⁸⁰ CFTC, Transaction Dollar Volume by Cleared Status (Apr. 9, 2014 10:43 AM), <http://www.cftc.gov/MarketReports/SwapsReports/L1TransDollarVolCS>.

to the traditional DCM regulatory framework, is new and will be tested. The number of SEFs will also pose a potential market fragmentation issue that must be analyzed.⁸¹

The regulatory waiting time of more than two years between the passage of Dodd-Frank and the publication of the SEF Final Rules (and a year and a half between proposing and finalizing the SEF rules) for both execution incumbents and new entrants has undoubtedly strained the resources of SEFs. In other words, trading traction will mean revenues and profits for SEFs. Given the number of SEFs and the competitive landscape, it will be informative to observe whether there is consolidation or exit of SEFs. While it is prudent regulation to require SEFs to maintain a year of operating expenses related to complying with the SEF core principles, this, too, will place additional strain on SEFs that are competing for market share.

VII. Conclusion

As noted at the outset of this article, it took over two years for the final SEF rules to be finalized and for the regulatory structure of the SEF to be outlined. Now, that regulatory structure is being implemented and realized. SEFs, as some had pontificated, will not be the next DTEF for the mere fact that SEFs have registered and they have trading volume.⁸² It is not clear how the SEF market structure will continue to develop -- that is whether there will be proliferation or consolidation. It is unique, though, that the driving force behind SEF proliferation is a federal trading mandate for certain products, as opposed to the more organic, market-driven evolution of the modern futures market. In the latter, consolidation was driven by electronic trading and a departure from a member-based exchange. In the former, consolidation may be driven by simple economics.

⁸¹ It is important to note that SEFs do not have a proprietary interest in the swaps that they list for trading. This is drastically different from a futures exchange that often has a proprietary interest in the products it lists for trading, including patents for product design. In other words, the proprietary interest in a specific product enables a futures exchange to capture all revenues related to that product, if it is adopted by market participants.

⁸² DTEF or “Derivatives Transaction Execution Facility,” was a creation of the Commodity Futures Modernization Act of 2000. A DTEF was statutorily defined to offer commodities for future delivery where the commodity had a nearly inexhaustible delivery supply, unlikely to be subject to manipulation and with an underlying commodity with no cash market, among other requirements. *See* Commodity Futures Modernization Act, 7 U.S.C. § 5a. Few, if any, DTEFs ever registered with the Commission and they ceased to exist under the Dodd-Frank Act. Registration of Intermediaries, 77 Fed. Reg. 51,898, 51,899 (Aug. 28, 2012) (stating that Dodd-Frank abolished DTEFs and created SEFs).