

A Big Step Toward Harmonizing Swap Trading Markets

By **Stephen Humenik and Uttara Dukupati** (February 1, 2018, 4:26 PM EST)

In a major development toward global harmonization of the swaps trading markets, on Dec. 8, 2017, the U.S. Commodity Futures Trading Commission issued an order exempting certain multinational trading facilities (MTFs) and organized trading facilities (OTFs) authorized within the European Union to trade derivatives from the requirement to register with the CFTC as swap execution facilities (SEFs). The order was made effective on Jan. 3, 2018.[1]

In September 2009, as economies emerged from the global financial crisis, the leaders of the G-20 agreed that “all standardized over-the-counter derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest.”[2] In the U.S, this agreement was given effect by the Dodd-Frank Wall Street Reform and Consumer Protection Act — a primary focus of which was implementing trading facilities for swaps and derivatives.

SEFs, created through Section 733 of the Dodd-Frank Act by the addition of Section 5h to the Commodity Exchange Act, were a prime example of such focus.[3] The Dodd-Frank Act required the trading and processing of certain swaps on SEFs and instituted pretrade price transparency in the swaps market. More broadly, the introduction of SEFs (and the continued use of designated contract markets, or DCMs) ensured certain swaps and derivatives were traded on an execution facility registered with the CFTC and subject to clearing (unless applicable exceptions governed).

CEA Section 5(h)(g) authorized the CFTC to exempt, conditionally or unconditionally, a SEF from registration under Section 5h if the commission found the facility was “subject to comparable, comprehensive supervision and regulation on a consolidated basis by ... the appropriate governmental authorities in the home country of the facility.”[4]

The CFTC found EU-wide legal requirements — including requirements under the EU’s New Markets in Financial Instruments Regulation (MiFIR), the EU’s amended Markets in Financial Instruments Directive (MiFID II) and the EU’s Market Abuse Regulation — established regulatory frameworks for MTFs and OTFs, which satisfied the CEA standard for granting an exemption from the SEF registration requirement.[5] Similar to the Dodd-Frank Act, and also as a response to the 2008 financial crisis, MiFID



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II and its companion regulations provide for a sweeping overhaul of financial product trading, which, ultimately, is intended to boost transparency and limit systemic risk across the EU.

The European Commission requested an exemption for each of the MTFs and OTFs listed in the order. As of Jan. 3, 2018, the EC represented that when the order became effective and requirements under MiFIR and MiFID II were implemented, each of the exempted MTFs and OTFs were authorized and in good standing in an EU member state that completed its transposition of MiFID II requirements. The order provided that the EC may request that additional MTFs and OTFs be added to the list, which exempted them from registering as SEFs with the CFTC, so long as they satisfy the requisite criteria.[6]

The order exempted 10 MTFs and six OTFs authorized within the EU from the SEF registration requirements.[7] Beginning on Jan. 3, 2018, market participants, subject to the CFTC's jurisdiction, were able to satisfy the CEA's swaps trading mandate by transacting on the aforementioned 16 trading venues. Additionally, to the benefit of the trading venues, participation by a U.S. person would not trigger the requirement that the MTFs or OTFs register as a SEF with the CFTC.

The EU's equivalent trading obligation required execution of certain swaps on regulated markets: MTFs, OTFs or certain third-country trading venues. For a third-country trading venue to qualify as a regulated market it is subject to certain EU requirements. Similar to CFTC requirements for EU trading venues, the EC had to determine that the legal and supervisory framework for trading venues of the relevant third country was equivalent to the EU's requirements for regulated markets, MTFs and OTFs. Further, third-country trading venues needed to be subject to effective supervision and enforcements in the third country. Finally, the third country was required to provide an effective system for the recognition of trading venues authorized under MiFID II.[8]

The EC adopted a decision on Dec. 5, 2017, finding the legal and supervisory frameworks of 14 DCMs and 23 SEFs sufficient. The EC's decision enabled EU counterparties to trade derivatives, subject to the EU trading obligation, on the approved DCMs and SEFs. The CFTC's order and the EC decision follow the Oct. 13, 2017, announcement of a common approach regarding the mutual recognition of certain CFTC- and EU-authorized derivative trading venues by CFTC Chairman J. Christopher Giancarlo and EC Vice President for Financial Stability Valdis Dombrovskis.[9]

By transacting on certain identified trading platforms, market participants are able to satisfy the applicable swaps or derivatives trading mandate in either jurisdiction. Without the combined efforts of regulators and implementation of the announced common approach, swap dealers and traders would have faced a regulatory-driven fragmented market when the EU's trading obligations took effect on Jan. 3, 2018. The common approach allows market participants to maintain trans-Atlantic trading relationships based on where they find liquidity and market makers. Ensuring that regimes have equivalent frameworks has been a major goal for regulators globally as they hope to prevent counterparties from circumventing rules by operating out of jurisdictions with looser standards. The CFTC is also looking to establish equivalence networks in Japan, Singapore, Hong Kong and Australia.

While the common approach is positive in the cross-border harmonization it brings about, it only captures those instruments that are subject to a trading mandate. With respect to the original goal of ensuring that derivatives were traded on registered exchanges and cleared, a market gap remains.

Finally, the CFTC order granting exempt SEF status to EU-authorized MTFs and OTFs does not affect other requirements under the CEA and the CFTC's regulations. The CFTC has particularly highlighted certain of these continuing requirements in the order, which include:

- Reporting requirements as they pertain to swap transactions
- Swaps entered into by a U.S. person who is not an eligible contract participant must be entered into on a DCM or subject to the rules of the DCM
- “Customer positions” must be cleared through commission-registered futures commission merchants (FCMs) at a commission-registered derivatives clearing organization (DCO)
- “Proprietary positions,” if intending to be cleared, must be cleared through a commission-registered DCO or a clearing organization that has been exempted from DCO registration by the commission
- All other transactions that require clearing must be cleared through a commission-registered DCO or an exempt DCO[10]

While the CFTC order provides OTFs and MTFs with relief from the more arduous process of functional equivalency, navigating the continuing requirements will still require close reading of the rules and careful compliance.

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[1] CFTC Approves Exemption from SEF Registration Requirement for Multilateral Trading Facilities and Organised Trading Facilities Authorized Within the EU (Dec. 8, 2017) available at <http://www.cftc.gov/PressRoom/PressReleases/pr7656-17>.

[2] Regulation on Over-the-Counter Derivatives and Market infrastructures (Mar. 29, 2012) available at http://europa.eu/rapid/press-release_MEMO-12-232_en.htm.

[3] 1 See 78 Fed. Reg. 33476 (Jun. 4, 2013), available at <http://www.cftc.gov/idc/groups/public/@Irfederalregister/documents/file/2013-12242a.pdf>.

[4] See 78 Fed. Reg. 33485 (Jun. 4, 2013), available at <http://www.cftc.gov/idc/groups/public/@Irfederalregister/documents/file/2013-12242a.pdf>.

[5] In the Matter of the Exemption of Multilateral Trading Facilities and Organised Trading Facilities

Authorized Within the European Union from the Requirement to Register with the Commodity Futures Trading Commission as Swap Execution Facilities — CFTC Order of Exemption (Dec. 8, 2017) available at http://www.cftc.gov/idc/groups/public/@requestsandactions/documents/ifdocs/mtf_otforder12-08-17.pdf.

[6] See id.

[7] See id.

[8] See Council Regulation 600/2014, 2014 O.J. (L 173), 84, 122 Art.

[9] See id.

[10] In the Matter of the Exemption of Multilateral Trading Facilities and Organised Trading Facilities Authorized Within the European Union from the Requirement to Register with the Commodity Futures Trading Commission as Swap Execution Facilities — CFTC Order of Exemption (Dec. 8, 2017) available at http://www.cftc.gov/idc/groups/public/@requestsandactions/documents/ifdocs/mtf_otforder12-08-17.pdf.