

**MEMO# 27296**

June 11, 2013

## **CFTC Adopts Final Rules for Swap Execution Facilities**

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TO: DERIVATIVES MARKETS ADVISORY COMMITTEE No. 46-13  
CLOSED-END INVESTMENT COMPANY MEMBERS No. 50-13  
INVESTMENT ADVISER MEMBERS No. 39-13  
SEC RULES MEMBERS No. 55-13 RE: CFTC ADOPTS FINAL RULES FOR SWAP EXECUTION FACILITIES

The Commodity Futures Trading Commission (“CFTC” or “Commission”) recently adopted final rules, guidance, and acceptable practices (“Final Rules”) to implement the requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) applicable to swap execution facilities (“SEFs”). [\[1\]](#) Those Final Rules that are most relevant to registered investment companies are summarized briefly below.

### **Scope of Final Rules**

The Dodd-Frank Act added Section 5h to the Commodity Exchange Act (“CEA”) regarding the registration and operation of SEFs, and added Section 2(h)(8) to the CEA, which requires that any swap that is required to be cleared must be executed on a designated contract market (“DCM”) or SEF, unless no DCM or SEF makes the swap “available to trade.” [\[2\]](#) The Final Rules require that a facility must be registered as a SEF if it “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 . . .” unless it is registered as a DCM. [\[3\]](#) In the Adopting Release, the Commission gave examples of various systems, platforms, and services, and discussed whether each would meet the definition of a SEF. The Commission stated that whether a particular entity falls within the definition of a SEF depends on the facts and circumstances of the entity’s operations.

Under the Final Rules, swaps subject to mandatory trading under the CEA are defined as “Required Transactions,” and all other swap transactions are “Permitted Transactions.” Required Transactions, other than block trades, must be transacted on a SEF or DCM.

### **Minimum Trading Functionality**

Required Transactions that are transacted on a SEF must be executed in accordance with

one of two methods of execution: (1) an “Order Book” [4] or (2) an “RFQ System,” which operates in conjunction with an Order Book. [5] An RFQ System is defined as a trading system or platform in which a market participant transmits a request for a quote (“RFQ”) to buy or sell a specific instrument to no fewer than three market participants in the trading system or platform, and to which all such market participants may respond. [6] For a one-year phase-in period, however, the Commission will require that RFQs be submitted to only two market participants. In adopting the Final Rules, the Commission concluded that the three market participant requirement, with the two market participant phase-in period, “appropriately balances the benefits of pre-trade price transparency and the information leakage concerns raised by commenters.”

The Final Rules further provide that a SEF that offers an RFQ System must ensure that: (1) at the same time the requester receives the first responsive bid or offer, the SEF communicates to the requester any firm bid or offer pertaining to the same swap resting on any of the SEF’s Order Books; (2) the SEF provides the requester with the ability to execute against the resting bids or offers along with any responsive orders; and (3) the SEF ensures that its trading protocols provide each of its market participants with equal priority in receiving RFQs and in transmitting and displaying for execution responsive orders. [7] The Commission clarified that SEFs are not required to disclose responses to RFQs to all market participants, and that it is not imposing a requirement that the identity of the RFQ requester be disclosed or remain anonymous, although an RFQ System must provide RFQ requesters with the option to make an RFQ visible to the entire market. The Commission also confirmed that an RFQ System may permit a transaction to be consummated even if the request does not yield three (or, in the first year, two) quotes. The Final Rules clarify that a SEF may use any means of interstate commerce for purposes of execution and communication, including, but not limited to, the mail, internet, email, and telephone, as long as the execution method satisfies the requirements for an Order Book or RFQ System.

The Final Rules also include a time delay for Required Transactions executed on an Order Book. [8] A broker or dealer that seeks to either execute against its customer’s order or execute two of its customers’ orders against each other through the SEF’s Order Book, following some form of pre-arrangement or pre-negotiation of such orders, is subject to at least a 15 second time delay between the entry of the two orders into the Order Book. The purpose of the time delay is so that one side of the potential transaction is disclosed and made available to other market participants before the second side of the potential transaction, whether for the broker’s or dealer’s own account or for a second customer, is submitted for execution. The SEF may, however, adjust this time delay based on a swap’s liquidity or other product-specific considerations, as long as the delay is of a sufficient period of time so that an order is exposed to the market and other market participants have a meaningful opportunity to execute against the order. The Commission noted that it does not have sufficient information at this time to make a determination whether asset managers executing trades on behalf of their clients would also be subject to the time delay requirement, and will work with SEFs to determine if the time delay requirement applies to asset managers or other market participants.

## **Confirmation Requirements**

The Final Rules require a SEF to provide each counterparty with written documentation of all terms of a transaction to serve as confirmation of the transaction, consistent with the requirement that a SEF report, for each swap executed on or pursuant to the rules of the SEF, confirmation data consisting of all terms of a transaction to a swap data repository. [9] While confirmation is required to take place at the same time as execution, the Final

Rules permit specific customer identifiers for accounts included in bunched orders to not be included in confirmations provided by the SEF if certain requirements are met. [\[10\]](#)

## **Protection of Proprietary Data and Personal Information**

The Final Rules permit a SEF to use proprietary data or personal information that it obtains from or on behalf of a customer, not just for regulatory purposes, but for business or marketing purposes if the person from whom the SEF collects or receives the information “clearly consents” to the use of its information. [\[11\]](#) The Final Rules specify, however, that a SEF may not condition access to its facility based on such consent. The Commission declined to adopt a definition of “proprietary data and personal information,” but recommended that SEFs define these terms in their rulebooks.

## **Rules, Guidance, and Acceptable Practices for Compliance with the Core Principles**

The Final Rules set out, in separate subparts B through P to part 37 of the Commission’s rules, the rules, guidance, and acceptable practices applicable to the 15 core principles (“Core Principles”) with which SEFs are required to comply initially and on a continuing basis, as a condition of registration. [\[12\]](#) This memorandum highlights just a few relevant rules and requirements related to certain of the Core Principles:

- Core Principle 2, among other things, requires a SEF to: (1) establish and enforce compliance with its rules; (2) establish and enforce trading, trade processing, and participation rules to deter abuses; and (3) have the capacity to detect, investigate, and enforce those rules. Core Principle 2 also requires that a SEF establish rules governing the operation of the facility, including rules specifying trading procedures to be used in entering and executing orders traded or posted on the SEF, including block trades.
  - The Commission confirmed that references to “market participant” in the Final Rules implementing Core Principle 2 mean a person that directly or indirectly effects transactions on the SEF, including a person with trading privileges on the SEF and persons whose trades are intermediated. [\[13\]](#)
  - The Final Rules implementing Core Principle 2 require that a SEF provide any eligible contract participant (“ECP”) and any independent software vendor (“ISV”) with impartial access to the SEF and its services, including any indicative quote screens, or any similar pricing data displays. The SEF must have: (1) criteria governing such access that are impartial, transparent, and applied in a fair and nondiscriminatory manner; (2) procedures whereby ECPs provide the SEF with written or electronic confirmation of their status as ECPs prior to obtaining access; and (3) comparable fee structures for ECPs and ISVs receiving comparable access to, or services from, the SEF.
  - The Commission also confirmed that the Final Rules implementing Core Principle 2 permit a SEF to modify or cancel a swap transaction without the consent of the counterparties under certain limited circumstances, such as in the case of a SEF’s technological error. The Final Rules require that any modifications or cancellations by the SEF be transparent to the market and subject to standards that are clear, fair, and publicly available to protect counterparties.
- Core Principle 6 requires that a SEF adopt for each swap, as is necessary and appropriate, position limits or position accountability to reduce the potential threat of market manipulation or congestion, and that for swaps that are subject to position limits under CEA Section 4a(a), the SEF must: (1) set its position limits at a level no higher than the position limitation established by the Commission; and (2) monitor

positions established on the SEF for compliance with the Commission's position limits, and any position limits set by the SEF. [14] The Final Rules implementing Core Principle 6 reflect these requirements, and provide SEFs with guidance on how to comply with these position limit rules until such time as compliance is required under part 151 of the Commission's rules.

- Core Principle 9 requires a SEF to make public timely information on price, trading volume, and other trading data on swaps to the extent prescribed by the Commission, and requires that the SEF have the capacity to electronically capture and transmit trade information with respect to transactions executed on the facility. The Final Rules implementing Core Principle 9 reflect these requirements, and specify that SEFs must report swap data as provided under parts 43 and 45 of the Commission's rules.
- Core Principle 12 governs conflicts of interest. The Final Rules require that a SEF: (1) establish and enforce rules to minimize conflicts of interest in its decision-making process; and (2) establish a process for resolving conflicts of interest. [15] The Commission noted that the substantive regulations implementing Core Principle 12 were proposed as part of a separate rulemaking that has not been adopted by the Commission. Until such time as they are, SEFs have "reasonable discretion" to comply with Core Principle 12, as stated in the Final Rules implementing Core Principle 12.

#### Effective and Compliance Dates

The Final Rules will become effective on August 5, 2013, with the exception of Rule 37.3(b)(5), which provides a 180-day period for the Commission to review SEF applications, which will become effective August 5, 2015. Compliance with the Final Rules is required by October 2, 2013 except that from August 5, 2013 until October 2, 2014 market participants may comply with the minimum quote requirement in Rule 37.9(a)(3) by transmitting an RFQ to no fewer than two market participants. [16]

Sarah A. Bessin  
Senior Counsel

#### endnotes

[1] See Core Principles and Other Requirements for Swap Execution Facilities, 78 Fed.Reg. 33476 (June 4, 2013), available at <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2013-12242a.pdf> ("Adopting Release").

[2] The CFTC also recently adopted final rules regarding how SEFs and DCMs will make a swap "available to trade" for purposes of Section 2(h)(8). For a summary of those rules, see ICI Memorandum No. 27267 (June 4, 2013), available at [http://www.ici.org/my\\_ici/memorandum/memo27267](http://www.ici.org/my_ici/memorandum/memo27267).

[3] Rule 37.3(a)(1) under the CEA.

[4] An Order Book is defined as (1) an electronic trading facility, as that term is defined in Section 1a(16) of the CEA, (2) a trading facility, as that term is defined in Section 1a(51) of the CEA, or (3) a trading system or platform in which all market participants have the ability to enter multiple bids and offers, observe or receive bids and offers entered by other market participants, and transact on such bids and offers. Rule 37.3(a)(3) under the CEA.

[5] Permitted Trades and block trades are not subject to these trade execution requirements. A SEF must, however, offer an Order Book for Permitted Transactions.

[6] Rule 37.9(a)(2) under the CEA. The three market participants cannot be affiliated with, or controlled by, the requester or affiliated with, or controlled by, each other.

[7] Rule 37.9(a)(3).

[8] Rule 37.9(b). Trades executed through an RFQ System are not subject to a time delay requirement, as the Commission believes that an RFQ System already provides sufficient pre-trade price transparency.

[9] Rule 37.6(b) under the CEA.

[10] Id.

[11] Rule 37.7 under the CEA.

[12] The Core Principles are: (1) Compliance with Core Principles; (2) Compliance with Rules; (3) Swaps Not Readily Susceptible to Manipulation; (4) Monitoring of Trading and Trade Processing; (5) Ability to Obtain Information; (6) Position Limits or Accountability; (7) Financial Integrity of Transactions; (8) Emergency Authority; (9) Timely Publication of Trading Information; (10) Recordkeeping and Reporting; (11) Antitrust Considerations; (12) Conflicts of Interest; (13) Financial Resources; (14) System Safeguards; and (15) Designation of Chief Compliance Officer.

[13] See Rule 37.201 under the CEA.

[14] Section 5h(f)(6) of the CEA.

[15] Rule 37.1200 under the CEA.

[16] The Adopting Release also provides that a SEF is required to comply with the warning letter requirement in Rule 37.206(f) no later than August 5, 2014. Rule 37.206(f) limits the number of warning letters per violation that may be sent when a SEF rule violation is found to have occurred.