

## First steps on the path forward

As US swap execution facilities go live, the EU's move to mandatory exchange trading continues. Here's what is helping, and impeding, harmonised US and EU responses to the G20 swap trading mandate

At their September 2009 summit in Pittsburgh, G20 leaders agreed that by no later than December 2012, all standardised over-the-counter (OTC) derivatives should be traded on exchanges or electronic trading platforms 'where appropriate'. No G20 member met this goal.

However, with the recent adoption by the US Commodity Futures Trading Commission (CFTC) of swap execution facility (SEF) rules, the US is much closer to meeting this target than its European peers. A US clearing mandate is in force as to major swap categories, SEF rules are now effective, the CFTC has approved its first SEF, and SEF trading is expected to commence this fall (although, as noted below, the CFTC retains considerable timing flexibility). In contrast, the equivalent EU rules for swap trading facilities are far from final and not expected to become effective until even as late as 2016.

The intensely global nature of derivatives trading can easily result in the application of multiple and incompatible legal requirements across legal systems. Absent coordination, adverse consequences could include incomplete compliance, regulatory arbitrage, political tensions, and fractured

liquidity. Given the differences in political institutions, rulemaking processes and implementation timeframes, as well as the diverse market structures and nomenclature, the US and EU in July announced an initiative to harmonise their approaches to swap execution. This makes it an opportune time to assess these transatlantic approaches and early harmonisation steps.

### Status update

#### US

The move towards regulated swap trading venues is part of sweeping legal changes intended to reshape the derivatives industry. In the US, Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) directs the CFTC and US Securities and Exchange Commission (SEC) to comprehensively regulate the OTC derivatives market. Title VII grants the CFTC and the SEC jurisdiction over 'swaps' and 'security-based swaps' (SBS), respectively, with the goals of promoting market transparency, stability and integrity. Swaps are a far greater portion of the market than SBS, and the CFTC has finalised most of its rules, including those for SEFs.

As to SEFs, Dodd-Frank amended the Commodity Exchange Act (CEA) to provide that all swaps that the CFTC subjects to mandatory clearing by a registered swaps clearing organisation must be executed on either a SEF or CFTC-designated 'contract market' (DCM), unless no SEF or DCM 'makes the swap available to trade'. The CFTC's first clearing mandate (November 2012) is now effective as to four interest rate swap and two credit default swap (CDS) classes. As of September 9 2013 all combinations of counterparty type and dealer pairings are subject to mandatory clearing. It should be noted that some end-user and inter-affiliate transactions are exempt from the clearing and therefore SEF execution mandates. Although coverage differs, similar

exemptions are proposed in the EU.

In May 2013, the CFTC issued three final regulations (described below) regarding SEFs, 'made available to trade' (MAT) determinations, and block trade sizes. Pursuant to a CFTC no-action letter, certain pre-SEF platforms may continue operation until their temporary SEF registrations are effective. Some platform operators have formed affiliated SEFs and expect to run existing platforms until the new SEFs are approved and 'live'. Absent specific CFTC relief, all platforms meeting the SEF definition (see below) must have an effective SEF registration by October 2 2013, or cease operation. Because some foreign exchange (FX) products are legally not 'swaps' (although subject to very similar documentation and reporting requirements) trading platforms specialising in these products may continue operation as non-SEFs. Dodd-Frank also created parallel requirements for SBS execution facilities (SB-SEFs). The SEC's proposed Regulation SB SEF is still pending after consultation phases.

#### EU

The EU situation is less final and more complicated. Derivatives rules are generally contained in two legislative texts: the Markets in Financial Instruments Directive (Mifid), and the European Market Infrastructure Regulation (Emir). Mifid is now being amended by two legislative forms: a Directive (called Mifid II) and Regulation (called Mifir). Mifid II will be effective once transposed into the law of the 28 member states. Mifir, once passed, will have direct effect.

Mifid II sets out standards for platforms on which swaps (among other transactions) will be executed. It is now in the so-called dialogue phase, in which the European Council and Parliament, with input from the European Commission (EC), thrash out under the Lamfalussy process for EU financial services regulation a Level 1 text containing framework principles. The EC will then develop Level 2 implementing measures with advice and input from the European Securities and Markets Authority (Esma). Esma will then draft and issue Level 3 interpretive recommendations and guidelines for national regulators.

Mifir is also a Level 1 text and addresses matters regarding the trading of derivatives and the related trading facilities. Mifir requires many derivatives to be traded only on regulated markets, multilateral trading facilities (MTFs) or a new type of trading facility – the organised trading facility (OTF). It also addresses pre- and post-trade

All platforms meeting the SEF definition must have an effective SEF registration by October 2 2013, or cease operation

transparency and transaction reporting. Once finalised and adopted, Mifir, Mifid II, and the necessary technical rules implementing them will become effective simultaneously.

### Harmonisation prospects

US and EU regulators share the G20 goal of moving swaps execution to a more transparent environment. However, any comparison of the CFTC's SEF regime to the corresponding EU rules must be tempered by the fact that, with the trialogue stage just started, and with implementing technical standards to be drafted, the EU derivatives trading regime is in a relatively early stage. Strikingly, however, the regulators have started initial steps towards harmonisation.

## The transatlantic swap execution regimes could converge significantly

A key step towards potential harmonisation of swap execution rules is a July 11 2013 CFTC-EC statement, known as the Path Forward. The most notable points in this agreement are as follows:

- The CFTC stated that it would 'clarify' that foreign boards of trade (FBOT) are among the boards of trade on which swaps that are subject to the clearing requirement may be executed. When a swap is executed on an anonymous and cleared basis on a SEF, DCM or FBOT, the counterparties will be deemed to have met their US transaction-level requirements, including the CFTC's trade execution requirement. (This clarification is embodied in the CFTC's July 12 Final Cross Border Interpretive Guidance and Policy Statement (CFTC Cross Border Guidance)).
- The regulators stated (arguably adding softness to the SEF trading deadline) that 'in the event that' the CFTC's trade execution requirement is triggered before March 15 2014, the CFTC will extend appropriate time-limited transitional relief to certain European MTFs until that date. (The reference to the 'trade execution requirement' makes it unclear whether the promised relief will extend to 'Permitted Transactions' (described below). Such a distinction

may be unintended since there would appear to be no policy justification.) This relief, including no-action letters, would be available for MTFs with sufficient pre- and post-trade price transparency, non-discriminatory access and appropriate oversight.

- Such relief, however, might not be limited to MTFs, but could be accorded to other types of trading platforms. The CFTC will consult with the EC in considering extension of this relief to other platforms that are subject to regulatory requirements that achieve comparable outcomes to the CFTC's. (Any relief to MTFs and other platforms would be more expansive than that available to FBOTs since FBOTs are CFTC-registered, while MTFs and other platforms are not.)
- They committed to assess progress in January 2014.

The CFTC's conditional acceptance of FBOTs in meeting the trade execution requirements and possible willingness to offer no-action relief to MTFs (and perhaps other trading platforms) suggest that despite existing differences, the transatlantic swap execution regimes could converge significantly. Moreover, given the contemplated March 2014 deadline for relief to EU MTFs, one could easily conclude that the CFTC is spurring the EU to narrow the implementation timing gap.

### The CFTC's rules

The CFTC adopted long-awaited SEF rules on May 16 2013. These have greater detail than the proposed EU scheme. The rules include:

- Core principles and other requirements for SEFs (SEF Rule);
- Process for a DCM or SEF To Make a Swap Available to Trade, Swap Transaction Compliance and Implementation Schedule, and Trade Execution Requirement Under the CEA (Made Available to Trade Rule); and
- Procedures to Establish Appropriate Minimum Block Sizes for Large Notional Off-Facility Swaps and Block Trades (Block Trade Rule).

### The SEF Rule

The CEA, as amended by Dodd-Frank, generally defines a SEF as a trading system or platform that is not a DCM, and in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants therein, through any means of interstate commerce. Due to the multiple-to-multiple element, single-dealer platforms are

excluded. The SEF Rule establishes registration requirements, execution methods, and core principles applicable to platforms whose functionality meets this definition.

## 'Made available to trade' is a term of art meaning more than mere listing by a SEF

All SEFs must comply with a minimum functionality requirement by offering an 'Order Book'. This is defined generally as an electronic trading facility, trading facility, or trading system or platform in which all market participants have the ability to enter multiple bids and offers, observe or receive bids and offers, and transact on them. The Order Book must be available for all SEF-executed swaps, even on SEFs that specialise in 'Permitted Transactions' (see below).

'Order Book' is a flexible concept. It need not be a 'central limit order book' and no particular price-matching algorithm is prescribed. There is no best execution or book-sweeping mandate. Execution methods could include traditional exchange pit trading and voice trading, so long as they satisfy the Order Book definition.

Acceptable SEF execution methods depend on whether a given swap is a 'Required Transaction', that is, a swap required to be cleared and executed on a SEF or DCM, or a 'Permitted Transaction', meaning all other (including exempted end-user) swaps.

### Required Transactions

Required Transactions, other than block trades, must be executed on an Order Book or a Request for Quote (RFQ) system by which market participants send a request for a quote to buy/sell a particular instrument to at least two (after October 2 2014, three) independent market participants. By contrast, SEC proposed Regulation SB-SEF permits a 1:1 RFQ. This is because a requester has the ability to request quotes from multiple participants if desired, and the SEC would require any RFQ transaction to interact fully with any responsive resting order book orders to assure best execution. The CFTC does not require Order Books to interact with RFQs to the same degree,

## A MAT determination binds the entire market, unless and until all relevant SEFs and DCMs have delisted the swap

although responsive firm bids or offers from the Order Book for Required Transactions must be fed to the RFQ requester so that it has the ability to lift and execute against them. SEF protocols must assure market participants equal priority in receiving requests for quotes and sending and displaying responsive orders.

Although most if not all pre-SEF RFQ systems are not anonymous, a SEF is not required to disclose the identity of an RFQ requester. Some CFTC pre-trade rules that apply to dealers do not apply to SEF trades if anonymous. Additionally, the CFTC's FBOT clarification in the Path Forward appears to state that anonymity is required in order for FBOT execution to satisfy CFTC transaction-level requirements, including the trade execution requirement. However, where permitted, dealers may prefer disclosure since this distinguishes customer trades from competitors' trades and facilitates so-called know your customer and good to trade checks.

For Required Transactions that are intermediated or executed on an Order Book, a SEF must require a broker/dealer seeking to either execute against a customer's order or execute two customer orders against each other to disclose one side of the transaction to the market for at least 15 seconds before the second side is submitted for execution. A SEF may adjust this delay period based upon a swap's liquidity or other product-specific considerations, so long as the delay is long enough for the order to be exposed to the market, and for other market participants to have a meaningful execution opportunity. The SEC's proposed Regulation SB SEF does not provide for a similar delay.

### Permitted Transactions

Permitted Transactions may be executed using any method of execution, including voice-based execution. Industry participants are concerned that *bona fide* hybrid or linked transactions, consisting of a Required Transaction and one or more Permitted Transactions or non-swaps, must have SEF execution of the Required Transaction leg,

even though the other legs affecting fair pricing either need not or cannot be SEF-executed.

Only an eligible contract participant (ECP) can trade on and have access to SEFs. SEFs must provide access to their markets and market services, including any indicative quote screens or similar pricing data displays, to any ECP or independent software vendor (ISV) on an impartial, transparent and non-discriminatory basis. Comparable fee structures must apply to similarly situated ECPs and ISVs. Some platform operators desiring to cater to specific clienteles (such as inter-dealer or customers) have created separate SEFs having rulebooks and execution methods designed to appeal to the targeted participants.

### The Made Available to Trade Rule

A swap that is subject to mandatory clearing must be executed on a SEF or DCM only if a SEF or DCM has made the swap available to trade. After listing, a SEF or DCM may make a MAT determination for a group, category, type or class of swap. 'Made available to trade' is a term of art meaning more than mere listing by a SEF. A SEF or DCM must make the initial determination that a swap is made available to trade based on any one or more of the following factors:

- existence of ready and willing buyers and sellers;
- frequency or size of transactions;
- trading volume;
- number and types of market participants;
- bid/ask spread; and,
- usual number of resting firm or indicative bids and offers.

The SEF or DCM must submit its written determination to the CFTC pursuant to either an approval or self-certification process. The former consists of a voluntary submission by the SEF or DCM, stating why each swap is made available to trade. The CFTC has a 45-day review period, although may (under conditions) extend this by another 45 days. Under the self-certification process (expected to be the predominant process), a

SEF or DCM must explain and analyse the operation, purpose and effect of making the swap available to trade, and how this satisfies the CEA. The CFTC has 10 business days to review the statement before it becomes effective, but may stay certification for up to 90 days, including a 30-day public comment period. The CFTC has stated an intention, at least initially, to take full advantage of its review and stay rights. The earliest effective MAT determinations are not expected until late 2013 or early 2014. Until then, all swaps are Permitted Transactions and may be executed OTC or optionally on SEF pursuant to the more liberal execution methods.

Thirty days after a MAT determination has been approved or deemed approved by the CFTC, continued OTC execution of such swap will generally be illegal. This is unless, in the particular circumstances, an exception to the mandatory clearing requirement applies. Other SEFs listing the same swap need not make an independent determination. Therefore, a MAT determination binds the entire market, unless and until all relevant SEFs and DCMs have delisted the swap. In practice, each MAT determination may be a one-way street, as the CFTC rejected suggestions favouring periodic reassessments as to whether a given swap remains available to trade.

The MAT Rule has generated controversy among market participants, some of whom argue that the six factors do not contain sufficiently objective standards. Some also argue that the determination should be left to the CFTC and not to SEFs, as SEFs will have a commercial incentive to determine that almost all swaps are available to trade. By contrast, under proposed Rule SB SEF a 'swap review committee' that is compositionally balanced would make MAT determinations for SBS. As noted below, under Mifir, Esma would make the equivalent determinations.

### The Block Trade Rule

The Block Trade Rule identifies large trades that may be transacted outside a SEF's Order Book or RFQ system, including by voice brokering, and be entitled to real time reporting delays. A separate CFTC regulation defining 'block transactions' states that they are executed 'away from' the mandatory trading systems, yet still 'pursuant to the SEF's or DCM's rules and procedures'. The Block Trade Rule provides swap categories and criteria for determining the minimum size at which transactions in each category become block trades. A SEF

may set a higher block size. While broad-based security basket and index swaps are swaps, and not SBS, under Dodd-Frank, the CFTC accords them no block trade treatment (other than CDS). By contrast, the SEC proposed that SBS data repositories calculate and disseminate block trade thresholds for reportable SBS, using SEC-specified criteria and formulae.

### SEF execution requirement under CFTC Cross-Border Guidance

Under the CFTC Cross Border Guidance, the SEF execution requirement generally will apply whenever: (i) a 'US person' (as defined by the CFTC) other than a foreign branch of a US bank that is a Swap Dealer or Major Swap Participant (MSP); or (ii) a US branch of a non-US Swap Dealer or MSP is a party to a swap. The CFTC Cross Border Guidance, however, contemplates a substituted compliance regime. Where available, this means that in certain transactions involving a foreign branch of a US Swap Dealer or MSP, or a non-US Swap Dealer or MSP, the CFTC will approve the application of the relevant foreign jurisdiction's swap execution requirements if the CFTC determines that they are comparable to and as comprehensive as corresponding US ones, including the CFTC's. The CFTC is reviewing substitute compliance requests for the EU, Australia, Canada, Hong Kong, Japan and Switzerland. As an alternative, in certain circumstances the parties may comply only with transaction-level requirements in the relevant non-US jurisdiction. This alternative is subject to quantitative limits and record-keeping conditions, and is available only if the relevant swap 'takes place' in a jurisdiction other than the EU and the five countries just enumerated. From this exclusion one might conclude that the CFTC believes that the EU and these countries are likely to implement comprehensive rules comparable to its own regulations, and that a favourable substitute compliance determination is likely.

### EU approach to derivatives trading platforms

The EU's schemes for the regulation of trading facilities are, at this stage, significantly less developed than in the US. However, given the CFTC-EC understandings, there is incentive for them to converge sufficiently to be comparable to the CFTC's rules.

Like the US before Dodd-Frank, Mifid in its existing form does not require swaps to be centrally cleared or executed on particular platforms. A stated aim of Mifid

II, however, is to assure that all organised trading, not only of derivatives but also of bonds and possibly (depending on dialogue outcome) cash equity securities, is conducted on a regulated trading venue, such as a regulated market, MTF or OTF, or a non-EU venue the legal and supervisory framework of which the EC has determined to be equivalent to the EU's. As to derivatives, the EC has stated that, under Mifid II, only *ad hoc* trading in non-standardised derivatives will continue to be allowed to take place OTC. Standardised derivatives will trade on organised venues, except for transactions entered into by

attaching to OTFs remains somewhat hazily defined. However, it is possible that a more liberal approach to voice execution could emerge than that contained in the SEF Rules. In addition, while OTFs, MTFs and regulated markets all must abide by transparent rules regarding access to the facility, an OTF will have the right to restrict access based on such factors as the role that the facility operators play in relation to their clients.

In contrast to the CFTC's MAT standard, under Mifir, Esma will assess whether a derivative that is clearing-eligible is 'sufficiently liquid' to be traded

## It is possible that a more liberal approach to voice execution could emerge in the EU than that contained in the SEF Rules

certain non-financial counterparties not subject to the clearing requirement under Emir, and certain intragroup transactions.

MTFs exist under Mifid, as it has effect today. They are understood to constitute multilateral systems, operated by an investment firm or market operator, bringing together multiple third-party buying and selling interests in financial instruments in accordance with non-discretionary rules to form contracts. In contrast, just as SEFs are new to the US, OTFs are new under Mifid II. The definition of OTF is expected to be sharpened as Mifid II progresses. Like a MTF, an OTF is operated by an investment firm or market operator, bringing together multiple third-party buying and selling interests in financial instruments to form contracts. Mifir, as proposed, contemplates that MTFs and OTFs will have identical pre- and post-trade transparency requirements, and may offer either order book or quote-driven systems.

However, unlike MTF operators, who are required to assure that MTF transactions are executed according to predetermined rules, an OTF operator will have a degree of discretion over how a transaction is executed. Consequently, OTFs will be subject to investor protection rules and best execution requirements, and an OTF operator will be prevented from executing trades against its own proprietary capital. Both MTFs and OTFs will be required to establish rules that outline objective criteria for the efficient execution of orders. As such, the degree of discretion

exclusively on OTFs, MTFs or regulated markets. Mifir requires that, in developing its implementing technical standards, Esma must take into account such factors as the average frequency of transactions, their average size, and the number and type of active market participants.

With regard to pre-trade transparency for derivatives, an MTF or OTF operator is required, based on its trading system, to make continuously available to the public during business hours, prices, the depth of trading interests and actionable indications of interest at those prices, for orders or quotes advertised through its system.

### Outlook

The CFTC is on the cusp of substantially satisfying the US's G20 execution commitment for standardised swaps. The SEC still must finalise its equivalent rules for SBS. The EU has considerable work ahead and institutionally, a more complicated process. The CFTC-EC Path Forward provides some incentive for the EU to close the gap, as well as a nascent harmonisation process and timeframe. The prospects for US-EU harmonisation are hopeful. But it must be recalled that the CFTC and SEC differ in their SEF/SB-SEF rules, definition of US person and proposed cross-border framework.

*By Morrison & Foerster Of counsel James E Schwartz and associate Marissa N Golden in New York, and Bank of America Merrill Lynch SVP and associate general counsel Robert J Dilworth in New York*