



## U.S. COMMODITY FUTURES TRADING COMMISSION

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Division of Clearing and Risk  
Division of Market Oversight  
Division of Swap Dealer and  
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November 14, 2013

To: All CFTC Registered Swap Execution Facilities and Applicants for Registration as a Swap Execution Facility

### **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**

The Division of Clearing and Risk (“DCR”), the Division of Market Oversight (“DMO”) and the Division of Swap Dealer and Intermediary Oversight (“DSIO”) (together, the “Divisions”) of the Commodity Futures Trading Commission (“Commission”) are issuing guidance (“Guidance”) to swap execution facilities (“SEFs”) and applicants for registration as a SEF concerning certain Commission regulations. This Guidance addresses certain restrictions related to swaps executed or traded on or subject to the rules of a SEF that are intended to be cleared (“Intended-To-Be-Cleared Swaps” or “ITBC Swaps”).<sup>1</sup> In addition, this Guidance addresses requirements placed on eligible contract participants (“ECPs”) for access to a SEF.

#### 1. Restrictions Relating to Intended-To-Be-Cleared Swaps

The Divisions understand that some market participants<sup>2</sup> ability to interact on a SEF’s trading systems or platforms for ITBC Swaps is restricted by the use of so-called “enablement mechanisms.” The Divisions use the term “enablement mechanism” broadly to refer to 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, whether by means of any condition or restriction on its ability or authority to display a quote to any other market participant or to respond to any quote issued by any other market participant on that SEF, or otherwise. For example, some SEFs establish that any two market participants may only execute

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<sup>1</sup> For purposes of this Guidance, the Divisions intend “ITBC Swaps” to include swaps that are (i) executed on or subject to the rules of a SEF; and (ii) intended to be submitted for clearing contemporaneously with execution. Such swaps are included regardless of whether the identities of the counterparties are anonymous or disclosed or whether the swap is subject to the trading requirement. The Divisions note that the term “ITBC Swaps” previously has been used in a slightly different context. *See* “No-Action Relief: Swaps Intended to be Cleared,” CFTC Letter No. 13-33 (corrected) (June 27, 2013). That definition is not applicable here.

<sup>2</sup> Market participant means a person that directly or indirectly effects transactions on a SEF. This includes persons with trading privileges on the SEF and persons whose trades are intermediated. *See* “Core Principles and Other Requirements for Swap Execution Facilities,” 78 Fed. Reg. 33476 at 33506 (June 4, 2013).

an ITBC Swap on a SEF's trading systems or platforms if the market participants have a pre-execution agreement, such as a breakage agreement.<sup>3</sup> Some SEFs limit the ability to stream indicative bids and offers to a subset of market participants, while other SEFs require that a market participant be a swap dealer or a clearing member in order to respond to a RFQ for an ITBC Swap, thus disallowing non-dealers from participating in the RFQ process as liquidity providers.<sup>4</sup>

Such restrictions are inconsistent with the impartial access requirement set forth in the Commodity Exchange Act ("CEA") and Commission regulation 37.202.<sup>5</sup> These provisions require a SEF to allow its market participants to fully access its trading systems or platforms with respect to ITBC Swaps. The statutory language of SEF Core Principle 2 requires that a SEF establish and enforce participation rules that "provide market participants with impartial access to the market."<sup>6</sup> Commission regulation 37.202(a) requires a SEF to provide any ECP and any independent software vendor ("ISV") with "impartial access to its market(s) and market services, including any indicative quote screens or any similar pricing data displays." The Commission stated in the preamble to the final SEF rules that the impartial access requirement is intended to allow market participants to "compete on a level playing field" and increase the participation of SEF liquidity providers to improve the pricing and efficiency of the market and reduce systemic risk.<sup>7</sup> The Commission further stated that "[i]mpartial access requirements protect market participants from discriminatory treatment by prohibiting similarly situated market participants from receiving different access terms and fee structures."<sup>8</sup> SEFs that apply or support enablement mechanisms that allow certain participants to interact with only certain other participants, or to interact in only certain ways, while other participants have broader abilities to interact, are imposing or allowing different access terms on similarly situated participants and are therefore engaging in prohibited discriminatory treatment.

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<sup>3</sup> The Divisions previously addressed the use of breakage agreements in the Staff Guidance on Swaps Straight-Through Processing. See "Staff Guidance on Swaps Straight-Through Processing" at 3 (Sep. 26, 2013) [hereinafter Straight-Through Processing Guidance] (describing clearing arrangements). The Divisions understand that some SEFs are permitting the enforcement of legacy breakage agreements, while others are incorporating breakage provisions into their rulebooks. The Divisions clarify that all such agreements and provisions as applied to ITBC swaps are inconsistent with the CEA and the Commission's regulations.

<sup>4</sup> Other examples of enablement mechanisms include arrangements that prevent market participants from interacting or trading with market participants that have not enabled them, requirements that a resting order entered by a non-dealer market participant in a market may be viewed and/or acted upon only by dealers, or only by parties that have specifically enabled that non-dealer participant, and requirements that a market participant may only interact if it satisfies minimum transaction volume levels.

<sup>5</sup> The Divisions understand that enablement mechanisms were historically used to eliminate credit risk. Such credit risk does not exist for ITBC swaps traded on or pursuant to the rules of a SEF. Under Commission regulations, ITBC swaps are subject to pre-execution credit checks and any trade that fails to clear will be void *ab initio* under SEF rules.

<sup>6</sup> 7 U.S.C. 7b-3(f)(2)(B)(i).

<sup>7</sup> See 78 Fed. Reg. at 33508 (agreeing with the comments of Mallers et. al., that the impartial access requirement allows ECPs to compete on a level playing field, and that the participation of additional liquidity providers will improve the pricing and efficiency of the market and reduce systemic risk).

<sup>8</sup> See 78 Fed. Reg. at 33573.

The Divisions believe that such restrictions also are inconsistent with respect to Order Book and request for quote (“RFQ”) system requirements.<sup>9</sup> The Commission’s regulations require a SEF to provide all its market participants—dealers and non-dealers alike—with the ability to fully interact on the Order Book or RFQ system, which includes, but is not limited to, viewing, placing, or responding to all indicative or firm bids and offers and, similarly, to place, receive and respond to RFQs. The Commission emphasized in the preamble to the final SEF rules that an Order Book, which a SEF must offer to meet the minimum trading functionality requirement under Commission regulation 37.3(a), must “allow market participants the ability to make executable bids and offers, and to display them to *all* other market participants on the SEF.”<sup>10</sup> Further, under Commission regulation 37.9(a)(3), a SEF that offers an RFQ system must provide an RFQ system that allows a market participant to transmit a request for a quote “to which *all* such market participants may respond.”<sup>11</sup> In addition, Commission regulation 37.9(a)(3)(iii) provides: “[t]he swap execution facility shall ensure that its trading protocols provide *each of its market participants* with equal priority in receiving requests for quotes and in transmitting and displaying for execution responsive orders.”<sup>12</sup> Thus, an RFQ system may not discriminate among groups of market participants and all such market participants must be provided the same facilities to interact.

In addition, if a swap dealer or futures commission merchant used (whether by an agreement or pursuant to a SEF’s rules) an enablement mechanism, this would constitute an arrangement that conflicts with Commission regulations 23.608 and 1.72.<sup>13</sup> Under Commission Regulation 23.608, “[N]o swap dealer or major swap participant entering into a swap to be submitted for clearing with a counterparty that is a customer of a futures commission merchant shall enter into an arrangement that .. (b) Limits the number of counterparties with whom a customer may enter into a trade; or ... (d) Impairs a customer's access to execution of a trade on terms that have a reasonable relationship to the best terms available.”<sup>14</sup> Similarly, Commission regulation 1.72 provides that “no futures commission merchant providing clearing services to customers shall enter into an arrangement that... (b) Limits the number of counterparties with whom a customer may enter into a trade; or ... (d) Impairs a customer's access to execution of a trade on terms that have a reasonable relationship to the best terms available.”<sup>15</sup> These provisions were designed to work in combination with the impartial access provisions of the SEF regulations to provide all market participants with the ability to fully interact on a SEF’s trading systems or platforms with respect to ITBC swaps.<sup>16</sup>

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<sup>9</sup> See Commission regulation 37.9(a)(3); 17 C.F.R. 37.9(a)(3) (setting forth requirements for an RFQ system).

<sup>10</sup> See 78 Fed. Reg. at 33484 (emphasis added).

<sup>11</sup> Commission regulation 37.9(a)(3); 17 C.F.R. 37.9(a)(3) (emphasis added).

<sup>12</sup> Commission regulation 37.9(a)(3)(iii); 17 C.F.R. 37.9(a)(3)(iii) (emphasis added).

<sup>13</sup> Commission regulation 23.608; 17 C.F.R. 23.608; Commission regulation 1.72; 17 C.F.R. 1.72.

<sup>14</sup> Commission regulation 23.608; 17 C.F.R. 23.608.

<sup>15</sup> Commission regulation 1.72; 17 C.F.R. 1.72.

<sup>16</sup> See “Customer Clearing Documentation, Timing of Acceptance for Clearing, and Clearing Member Risk Management,” 77 Fed. Reg. 21278 at 21280 (April 9, 2012).

2. Access Requirements for Eligible Contract Participants

Restrictive requirements on ECPs to obtain access are inconsistent with the impartial access requirements in Commission regulation 37.202(a).<sup>17</sup> SEF rules specifically require market participants on a SEF to be ECPs, as defined in Commission regulation 1.3(m).<sup>18</sup> While the preamble to the final SEF rules states that a SEF may exercise its own “reasonable discretion”<sup>19</sup> in establishing access criteria, such criteria must be “impartial, transparent, and applied in a fair and nondiscriminatory manner.”<sup>20</sup> As noted earlier, the Commission made it clear in the preamble that “the impartial access requirement allows ECPs to compete on a level playing field, and that the participation of additional liquidity providers will improve the pricing and efficiency of the market and reduce systemic risk.”<sup>21</sup> Accordingly, limiting access to a SEF’s trading systems or platforms to certain types of ECPs or ISVs is inconsistent with “the impartial access requirement of Core Principle 2.....”<sup>22</sup>

For example, the Divisions have learned that some SEFs provide access to an ECP that is either a liquidity provider or a liquidity taker, but not to an ECP that is both a liquidity provider and taker. Some SEFs also prohibit an individual from obtaining access, even if such individual comes within the definition of an ECP.<sup>23</sup> Other SEFs limit access to ECPs that satisfy minimum transaction volume level requirements; and others require that an ECP be a clearing member or have an agreement with a clearing member to access the SEF even just to trade swaps that are not intended to be cleared. The Divisions view these ECP qualifications to be inconsistent with the impartial access requirement as they limit access to certain types of ECPs.

In addition, the Divisions have learned that some SEFs are allowing only intermediated access to the SEF, while other SEFs are allowing only direct access. The Divisions are concerned that in some circumstances these provisions may impede impartial access. The Divisions expect SEFs to re-examine their rulebooks and ensure that the rules they adopted do not impede impartial access.

The Divisions further point out that a requirement by a SEF that a market participant has a clearing agreement with a clearing member or be a clearing member before it executes a swap intended to be cleared is necessary for the SEF to be compliant with Commission regulation 37.702.<sup>24</sup> However, the Divisions here again are concerned with a SEF’s requirement that a market participant also execute that trade through the clearing member, and not by direct access, may impede the impartial access requirement. Once a trade is guaranteed by a clearing member,

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<sup>17</sup> See Commission regulation 37.202(a); 17 C.F.R. 37.202(a).

<sup>18</sup> See Commission regulation 37.702(a); 17 C.F.R. 37.702(a).

<sup>19</sup> See 78 Fed. Reg. at 33508.

<sup>20</sup> Commission regulation 37.202(a); 17 C.F.R. 37.202(a).

<sup>21</sup> See 78 Fed. Reg. at 33508.

<sup>22</sup> *Id.*

<sup>23</sup> See Commission regulation 1.3(m); 17 C.F.R. 1.3(m).

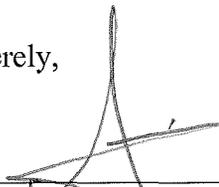
<sup>24</sup> See Straight-Through Processing Guidance at 3 (describing clearing arrangements).

the Divisions see no reason for a SEF to require that the execution also be done through that clearing member.<sup>25</sup>

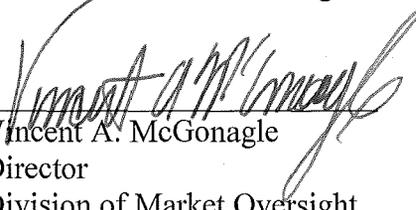
The Divisions remind SEFs that they may make changes to their rulebooks at any time, pursuant to either the certification or approval procedures set forth in part 40 of the Commission's regulations, provided that such rule changes are not inconsistent with the Act or the Commission's regulations.

This Guidance supplements previous Guidance issued by the Divisions on these topics. This Guidance, and the positions taken herein, represent the views of the Divisions only, and do not necessarily represent the views of the Commission or of any other office or division of the Commission. If you have any questions concerning this Guidance, please contact John Lawton, Deputy Director, Division of Clearing and Risk, at (202) 418-589 or [jlawton@cftc.gov](mailto:jlawton@cftc.gov), Frank Fisanich, Deputy Director, Division of Swap Intermediary Oversight, at (202) 418-5949 or [FFisanich@cftc.gov](mailto:FFisanich@cftc.gov), Nancy Markowitz, Deputy Director, Division of Market Oversight, at (202) 418-5453 or [nmarkowitz@cftc.gov](mailto:nmarkowitz@cftc.gov), Jonathan Lave, Associate Director, Division of Market Oversight, at (202) 418-5983 or [jlave@cftc.gov](mailto:jlave@cftc.gov), or Nhan Nguyen, Special Counsel, Division of Market Oversight, at (202) 418-5932 or [nnguyen@cftc.gov](mailto:nnguyen@cftc.gov).

Sincerely,



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<sup>25</sup> The Division of Market Oversight and the Division of Clearing and Risk noted in the Straight-Through Processing Guidance that orders which have satisfied the Clearing FCMs' pre-execution limits are deemed accepted for clearing and thereby subject to a guarantee by the Clearing FCM upon execution. See Straight-Through Processing Guidance at 3.