Discussion Topics Concerning Swap Execution Facilities (SEFs) under the Dodd-Frank Act (DFA)

The SEF definition as well as the operative provisions of the DFA specify that SEFs perform three discrete functions – they provide the platform to: (i) "trade"; (ii) "execute"; and (iii) "trade process" the swaps.[1] Because the legislator used these specific and distinct terms, it appears that the legislative intent is to describe three separate and distinct functions of the SEFs, which are accordingly grouped into three categories described below: (a) Category I – the "*Trading Facility SEF*"; (b) Category II – the "*Execution Facility SEF*" (with three subcategories A, B, and C); and (c) Category III – the "*Trade Processing / Confirmation Facility SEF*" (or a Non-Execution Facility SEF). It also appears that the legislative intent was to require that _**all**_ transactions benefit from legal confirmation, processing, netting, documentation, and valuation of all swaps, aggregate reporting and other services provided by Category III SEFs. It is possible that the same SEF entity would be able to qualify as Category I, II and III SEF or as either of these categories taken separately.

Categories of SEFs	Applicable Provisions in the DFA and the CEA	Functionality	Liquidity / Frequency of Trades	Regulation / Comments	Existing Examples	Regulatory Implications / the "Trading Requirement" Waterfall
Category I **"Trading Facility" SEF**	- "Multiple participants have the ability to execute or trade agreements, contracts, or transactions… through the interaction of multiple bids or multiple offers within a system with a predetermined non-discretionary automated trade matching and execution algorithm" ; (CEA 1a(34)(A)(ii))[2] - Makes "available for trading any swap" (DFA, CEA 5(h)(b)(1)(A))[3]	Exchange-type *algorithmic matching* and an open order book of trades	Liquidity High, Multiple bids / offers	SEF Definition[4] and SEF operative provisions.[5] SEF definition specifically includes "trading facilities". Regardless of the method of trading and execution, all trades must be confirmed on Category III SEF (or by Category I SEF with Category III SEF functionality).	Many existing exempt commercial markets (ECMs) – trading facilities	***Exchange-Type or Trading Facility***. For exchange-type "trading facilities"; most of the rules and regulations applicable to ECMs and the SEF new core principles will apply in full. Mandatory trading requirement for cleared swaps with sufficient trading characteristics _**will be**_ satisfied on these SEFs.

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[1] *See* suggested definitions for these terms provided at the end of this document in Explanatory Notes.

[2] *See* Commodity Exchange Act (**CEA**) Sec. 1a(34)(A)(ii) – numbering before the amendment by the DFA.

[3] CEA after amendment by the DFA. *Also, see* B. Lincoln colloquy to the Senate below.

[4] DFA §721 "(50) SWAP EXECUTION FACILITY.-The term 'swap execution facility' means 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."

[5] DFA §733. "5h. SWAP EXECUTION FACILITIES. (a) REGISTRATION.- (1) IN GENERAL.-No person may operate a facility for the trading or processing of swaps unless the facility is registered as a swap execution facility or as a designated contract market under this section. (2) DUAL REGISTRATION.- Any person that is registered as a swap execution facility under this section shall register with the Commission regardless of whether the person also is registered with the Securities and Exchange Commission as a swap execution facility.(b) TRADING AND TRADE PROCESSING.- (1) IN GENERAL.-Except as specified in paragraph (2), a swap execution facility that is registered under subsection (a) may-(A) make available for trading any swap; and (B) facilitate trade processing of any swap. (2) AGRICULTURAL SWAPs.-A swap execution facility may not list for trading or confirm the execution of any swap in an agricultural commodity (as defined by the Commission) except pursuant to a rule or regulation of the Commission allowing the swap under such terms and conditions as the Commission shall prescribe. (c) IDENTIFICATION OF FACILITY USED TO TRADE SWAPS BY CONTRACT MARKETS.- A board of trade that operates a contract market shall, to the extent that the board of trade also operates a swap execution facility and uses the same electronic trade execution system for listing and executing trades of swaps on or through the contract market and the swap execution facility, identify whether the electronic trading of such swaps is taking place on or through the contract market or the swap execution facility. (d) RULE-WRITING.- (1) The

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Category II **Execution Facility SEF** *(with 3 subcategories A, B, and C)*	- "Multiple participants have the ability to execute or trade agreements, contracts, or transactions…by accepting bids of offers made by other participants that are open to multiple participants in the facility or system" (CEA . 1a(34)(A)(i))	Facility where *trades are binding* when executed on the platform, but no algorithmic matching	Liquidity High, Multiple bids / offers	Meets the definition of a "trading facility" in the CEA (first prong of the definition). Regardless of the method of execution, all trades must be confirmed on Category III SEF (or by Category II SEF with Category III SEF functionality).	Execution facility	*(A) Multiple Participant Execution Facility*. Most of the ECM provisions and new core principles will apply, except that automatic algorithmic matching provisions need not apply. Mandatory trading requirement for cleared swaps with sufficient trading characteristics **_will be_** satisfied on these SEFs.
	- "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 … that- - facilitates the execution of swaps between persons" (DFA, CEA 1a(50)) - Makes "available for trading any swap" (DFA, CEA 5(h)(b)(1)(A)).[6]	Implies only *multiple to multiple* trading and execution is included	Liquidity High, Multiple bids / offers	SEF definition in the DFA that describes SEFs that are other than "trading facilities". It is possible to demonstrate multiple-to-multiple participation on some (request for quote) RFQ platforms.	RFQ, *inter*dealer platforms with active participation of multiple participants will qualify	
		"have the ability" and "facilitates" may imply that 1-to-1, 1-to-many, illiquid RFQ, voice brokerage facilities may be included	Liquidity Low, Very few or no multiple bids / offers	Some non-multiple to multiple facilities will qualify. The definition of the SEF clearly shows legislative intent to include in the definition some facilities *in addition to* simply "trading facilities"; otherwise legislator would have simply merged the SEF definition with the DCM (exchange – trading facility) definition.	Illiquid RFQ facility; voice brokerage facility; *intra*dealer platforms	*(B) Non-Multiple Participant Execution Facility*. Some of the new core principles will apply. Mandatory trading requirement for cleared products **_will be_** satisfied on these SEFs, provided that: (i) they are registered; (ii) the contract is "illiquid" to fulfill multiple-to-multiple trading requirement; and (iii) real time reporting requirements are

Securities and Exchange Commission and Commodity Futures Trading Commission may promulgate rules defining the universe of swaps that can be executed on a swap execution facility. These rules shall take into account the price and nonprice requirements of the counterparties to a swap and the goal of this section as set forth in subsection (e). (2) For all swaps that are not required to be executed through a swap execution facility as defined in paragraph (1), such trades may be executed through any other available means of interstate commerce. (3) The Securities and Exchange Commission and Commodity Futures Trading Commission shall update these rules as necessary to account for technological and other innovation. (e) RULE OF CONSTRUCTION.-The goal of this section is to promote the trading of swaps on swap execution facilities and to promote pre-trade price transparency in the swaps market.

[6] In connection with this phrase, note that Senate Agriculture Committee Chairman B. Lincoln in her colloquy stated: "the CFTC should take a practical rather than a formal or legalistic approach…whether, as a practical matter, it is in fact possible to trade a swap on the facility… should consider… whether there is a minimum amount of liquidity such that the swap can actually be traded on the facility, without a minimum amount of liquidity to make trade possible, should not be sufficient to trigger the Trade Execution Requirement." ("**Lincoln Colloquy**" – Congressional Record – S5919, July 15, 2010).

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						met (as specified for this facility).
		"have the ability" and "facilitates" implies that negotiation of *non-binding* trades is possible if "facilitates" execution of swaps	Liquidity Low, No multiple bids / offers	Not all of the core principles will apply. This type of facility allows participants to negotiate and execute a binding trade on the facility. Regardless of the method of execution, all trades must be confirmed on Category III SEF (or by Category II SEF with Category III SEF functionality).	Negotiation facility; bulletin board-type facility	*(C) Negotiation Facility*. Some of the new core principles will apply. Mandatory trading requirement for cleared products **_will be_** satisfied on these SEFs, provided that: (i) they are registered; (ii) the contract is "illiquid" to fulfill multiple-to-multiple trading requirement; and (iii) real time reporting requirements are met (as specified for this facility).
Category III **Trade Processing / Confirmation Facility SEF**	- "No person may operate a facility for the trading **_or processing_** of swaps unless the facility is registered as a swap execution facility… under this section." (DFA, CEA 5(h)(a)(1)). - "**_facilitate trade processing_** of any swap" (DFA, CEA 5(h)(b)(1)(B)).	Electronic screen based trade processing and confirmation process. Trading (and execution) functionality is captured by Categories I and II. No algorithmically matched or executed trades occur on the platform; multiple is likely satisfied by open access to the platform; block trades	High or Low, or None (*e.g.*, only two participants in the market) Can accommodate trade processing of *every possible* transaction *regardless of how* it is traded, executed, negotiated	This provision is much broader than the definition of the SEF because mandates *any entity* trading **_or_** processing swaps to register as a SEF. Note, the definition does not say that a SEF must register, but states instead that any entity that performs trading or trade processing functions must register as a SEF §733. Will depend on how the CFTC further defines "trading or processing of swaps" (see suggested definitions below). Such facility need not **_both_** trade and process, merely trade	Electronic trade processing and confirmation facilities	*Trade Processing and Confirmation Facility (the non-execution SEF)*. Some of the new core principles will apply. Mandatory trading requirement for cleared products **_will be_** satisfied on these SEFs, provided that: (i) they are registered; (ii) the contract is "illiquid" to fulfill multiple-to-multiple requirement; and (iii) real time reporting requirements are met (as specified for this facility). To fulfill the confirmation requirement in business standards, swap dealers and major swap participants **_must_** trade process, confirm or affirm trades on SEFs of this category or on facilities that perform the

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		are possible and other non-competitive forms of execution (analogy to EFP, EFS, give-ups, *etc*.). Provides trade information capture, legal confirmation, audit trails, *etc*.	or cleared.	processing is sufficient to be subject to registration if this SEF intends to fulfill the mandatory trading requirement in the DFA on this facility.		trade processing functions (that by definition in the DFA must register as SEFs).[7] Category I and Category II SEFs may contract with or delegate to Category III SEF to fulfill their "trade processing" requirements of data capture, legal confirmation, *etc*.

<u>Explanatory Notes</u>:

"**Trading**" – *The term "trading" of swaps on a swap execution facility means the interaction of multiple bids or multiple offers within a system with a predetermined non-discretionary automated trade matching and execution algorithm.*

"**Execution**" – *The term "execution" of swaps on a swap execution facility means accepting bids or offers made by other participants that are open to multiple participants in the facility or system.*

"**Trade processing**" – *The term "processing" or "trade processing" of swaps on a swap execution facility means: (i) electronic confirmation, affirmation or any other electronically recordable method of interstate communication used by two participants to document a legally binding swap; or (ii) electronic negotiation of the terms of and entering into bilateral transactions in swaps as a result of communications exchanged by participants and not as a result of trading or execution of swaps; or (iii) posting on the swap execution facility of non-competitively executed swaps entered into by two participants by means of block trades, give ups, exchanges of risk, or any other lawful method of competitive or non-competitive execution authorized by the Commission.*

"**Make available for trading**" – *The phrase "make available for trading" means: (i) making the swap execution facility available for trading by participants of an instrument that the CFTC has determined is subject to the trading requirement in section 2(h)(8) of the Act[8] and the swap*

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[7] *See* DFA §731; CEA §4s(i) as amended by the DFA. To carry out documentation and recordkeeping requirements of the DFA, the CFTC should consider adopting a rule requiring that all swap trades, regardless of whether they are cleared or not, be documented, trade processed, confirmed or affirmed on SEFs of Category III (unless they are already documented or confirmed on SEFs of Categories I and II via the functionalities of Category III).

execution facility can demonstrate sufficient liquidity in the instrument consistent with prevailing market practices; (ii) making the swap execution facility available for execution by participants of an instrument that the CFTC has determined is subject to the trading requirement in section 2(h)(8) of the Act; and (iii) trade processing of such swap in the event that trading or execution is not possible as a result of insufficient market liquidity for such swap, a small number of participants trading or executing such swap, or a high degree of customization of such swap. The phrase "facilitates the execution of swaps between persons" shall have the same meaning.

Additional Requirement to Consider (under DFA §731 and CEA §4s(i) – Documentation Standards for Swap Dealers and Major Swap Participants):

To ensure that swap dealers and major swap participants not only report their open positions to the swaps data repositories and the Commission, but also maintain an audit trail of all their trades, the swap dealers and major swap participants must be obligated to electronically confirm their swap trades to maintain detailed electronic audit trails of all their transactions in swaps. The requirement of "trading" and "execution" of swaps will ensure that swap execution facilities and the designated contract markets will maintain their audit trails and will generate confirmations; particularly, if the SEFs and DCMs are required to perform all the confirmation, affirmation and data capture functions performed by the Category III SEFs. However those swaps that are not traded or executed on the SEFs or the DCMs, and are either cleared or not cleared – must be trade processed to ensure that they are properly confirmed and that a detailed audit trail is created in every instance.

"It shall be unlawful for a swap dealer or a major swap participant to enter into swaps unless such swap dealer or a major swap participant trades, executes, or trade processes the swap on a swap execution facility.".

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[8] It is expected that the CFTC rule-making will require two components of "make available for trading" for Category I SEFs: (1) the CFTC has determined that the particular instrument has appropriate characteristics (liquidity, standardization, *etc*.) such that it may be traded on a Category I SEF, **_and_** (2) a Category I SEF actually offers the instrument for trading (with "offers for trading" being defined to require specific liquidity metrics, *e.g.,* minimum number of bids/offers, spreads, *etc*.). The regulations should not require a particular manner of trading or execution that cannot be achieved, thereby actually eliminating liquidity that exists today.