

## CFTC Adopts Final Rules Requiring Execution of Swaps on Organized Facilities

On May 16, 2013, the U.S. Commodity Futures Trading Commission (the “CFTC”) adopted several rules relating to swap execution. These much-anticipated rules make three significant changes to the regulatory framework of derivatives: first, they create a new regulated entity – the registered swap execution facility (“SEF”); second, they detail the minimum trading functionality required of SEFs; and, third, they implement a trade execution requirement that mandates that certain swaps be executed on a SEF or a designated contract market (“DCM”). Collectively, these rules, together with the mandatory clearing requirement for certain derivatives, will transform how derivatives are traded.

In addition, the CFTC contemporaneously approved block trade rules, which group swaps into subcategories within each asset class and establish threshold notional amounts for each subcategory that, if elected, will trigger treatment of a swap transaction as a block trade. Swaps transactions treated as a block trade will enjoy a delay in public reporting, will not be subject to the trade execution requirement, and may be reported using a capped notional amount (rather than the full notional amount).

Certain key provisions of these rules for funds and advisers are described further below.

### Trade Execution Requirement and SEF Registration Rules

Under the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd Frank”), all swap transactions that are subject to the mandatory clearing requirement must be executed on a SEF or DCM unless no SEF or DCM makes the swap “available-to-trade” (or the transaction qualifies for block trade treatment, as discussed below). Dodd Frank defines a SEF as a trading platform where *multiple participants* have the ability to execute swaps by accepting bids and offers made by *multiple participants* in the platform.

Any swap transaction that is subject to this trade execution requirement and that is not a block trade (a “Required Transaction”) must be executed on a SEF via either an order book or via a request for quote (“RFQ”) system that operates in conjunction with an order book. An order book generally means a system in which market participants enter multiple bids and offers, observe or receive bids and offers entered by other market participants, and transact on such bids and offers. An RFQ system is generally a system in which a party who wants to enter into a swap submits requests for quotes from select counterparties and executes against any quote received in response.

One of the most controversial requirements of the proposed SEF rules was the number of counterparties to whom an RFQ must be submitted. The proposed rules required that a RFQ be submitted to at least five counterparties. The CFTC eased that restriction in the final rules, which require that the RFQ-requester issue its RFQ to at least two potential counterparties during the initial phase of implementation (such initial phase beginning 120 days after publication of the rule in the Federal Register and lasting for one year) and to at least three potential counterparties thereafter. As mentioned above, SEFs can provide RFQ functionality only if the RFQ functionality works in conjunction with the order book. Specifically, when a SEF facilitates the provision of the first response to an outstanding RFQ, the SEF is required to also provide the RFQ-requester: (i) with any executable resting bids or

offers in the same instrument from any of the SEF's order books and (ii) with the ability to execute against such firm resting bids or offers. There is no requirement, however, for the RFQ-requester to accept the most favorable price.

As a result of these new requirements, certain methods commonly used to execute derivatives will no longer be permitted for Required Transactions. For example, entering into Required Transactions by telephone will be allowed only if the telephone trading system meets the requirements of a SEF provided in the rules, including that the trade be executed via an order book or via an RFQ in conjunction with an order book. Also, the CFTC explained in the rule release that one-to-many systems where the sponsoring entity acts as counterparty to all swap contracts executed through the system would not qualify as a SEF and, accordingly, one-to-many systems will no longer be able to facilitate Required Transactions after the compliance date.

In addition to establishing the minimum trading functionality required of SEFs, the SEF Rule also lays out the registration requirements for SEFs. The rule envisions a temporary registration akin to the provisional registration of swap dealers, during which the CFTC will thoroughly review the SEF's application materials. The CFTC noted that it may receive more than 20 SEF applications. The rule also contains detailed provisions regarding the regulation and requirements of SEFs, including 15 core principles. Among these requirements are the following notable concepts:

- SEFs must provide impartial access to their markets to any eligible contract participant and any independent software vendor.
- To prevent market disruptions, SEFs must implement trade risk control mechanisms, including pauses and halts to trading, under certain conditions.

### Available-to-Trade Determinations

As noted above, a swap transaction is required to be executed on a SEF or a DCM only if a SEF or DCM makes the swap "available-to-trade" and it is subject to the mandatory clearing requirement. Mere listing or offering of a swap for trading does not mean that the swap is "available-to-trade" for this purpose.

For a swap to be determined "available-to-trade," a SEF or DCM must submit an analysis and explanation to the CFTC of why the SEF/DCM believes the swap (or a group, category, type or class of swaps) is available-to-trade. The submission must address one or more of the following factors:

1. whether there are ready and willing buyers and sellers;
2. the frequency or size of transactions;
3. the trading volume;
4. the number and types of market participants;
5. the bid/ask spread; and/or
6. the usual number of resting firm or indicative bids and offers.

The CFTC explained that no single factor must always be considered in available-to-trade determinations, nor must more than one factor always be considered. In addition to a discussion of at

least one of the above factors, the SEF/DCM making the submission must also certify that it is listing the swap. The SEF/DCM need not, however, fulfill a minimum listing period before it can make the submission. In its submission, a SEF/DCM can consider activity in the same swap listed on another SEF/DCM as well as bilateral, off-exchange activity in the same swap.

There are two different processes that a SEF/DCM can initiate to receive a determination that a swap is “available-to-trade”: (i) the § 40.5 rule approval process and (ii) the § 40.6 SEF/DCM rule self-certification process. In both processes, the available-to-trade determination is a new rule of the SEF/DCM. Under the § 40.5 rule approval process, a registered SEF/DCM submits a rule request to the CFTC that a swap be deemed available-to-trade. The CFTC has 45 days to review the request. During that time, market participants may comment. The CFTC may extend its review period for an additional 45 days if the rule raises novel or complex issues that require additional time for review, if the rule is of major economic significance, if the submission is incomplete, or if the requestor does not respond completely to the CFTC’s questions in a timely manner, and the CFTC may extend the review longer still if the SEF/DCM so agrees in writing. Under the § 40.6 SEF/DCM rule self-certification process, a registered SEF/DCM submits a rule for certification to the CFTC that a swap is available-to-trade. The CFTC has 10 days to review the rule before it is deemed certified and made effective. The CFTC may, however, stay that certification for as long as 90 days, during which there is a 30 day mandatory public comment period.

Depending on the process used by the SEF/DCM for submission, the CFTC may approve/allow the swap to be deemed available-to-trade, or the CFTC may object to the available-to-trade determination because such determination is (or appears to be) inconsistent with the Commodity Exchange Act or CFTC regulations. Once a swap is determined to be available-to-trade, all other SEFs/DCMs that list or offer that swap must do so in accordance with the trade execution requirement. The CFTC will publish on its website a list of available-to-trade swaps along with the SEFs/DCMs that list or offer those swaps.

Initially, the CFTC will review available-to-trade submissions only for swaps that it has already determined to be subject to the mandatory clearing requirement. Additionally, the CFTC hinted that for the first available-to-trade submissions that it receives, it will likely extend the review period, though it did not definitively commit to do so. Specifically, the CFTC explained that initial available-to-trade determinations “may” present novel and complex issues that will warrant retention for an additional review. Therefore, swaps submitted to the CFTC for an available-to-trade determination may be subject to a review period of up to 90 or 100 days, depending on the process of submission chosen by the SEF/DCM (*i.e.*, the § 40.5 rule approval process or the § 40.6 SEF/DCM self-certification process, respectively).

## Block Trade Rule

As described in our prior [Alert](#), Dodd Frank requires real-time public reporting of swap transaction and pricing data. But real-time reporting of large swap transactions (*i.e.*, “block trades”) may deter liquidity providers from acting as counterparties for these large trades. If market participants are made aware of a liquidity provider’s large position in real-time, those market participants might attempt to exact a premium from the liquidity provider when they seek to offset their risk (*i.e.*, predatory trading). The CFTC has adopted block trade rules that mitigate this concern by establishing threshold swap notional

amounts for off-exchange swaps, above which public reporting is delayed and the mandatory trade execution requirement falls away. While block trades that would otherwise have been subject to the trade execution requirement are required to be executed pursuant to the rules of a SEF, they are not required to be executed through the SEF's order book or RFQ system.

Because the notional amount that will move the market in one product is different from the notional amount that will move the market in another product, the block trade rule groups swaps in each of the five asset classes (rates, credit, equities, FX, and other commodities) into categories and assigns each swap category a different notional amount threshold that triggers block trade treatment. Swaps in the rates asset class are categorized by tenor and currency; swaps in the credit asset class are categorized by tenor and spread; swaps in the equities asset class are categorized into only one category; swaps in the FX asset class are categorized by currency pair; and swaps in the other commodities asset class are categorized by whether the swap is economically related to a futures contract and whether that futures contract is subject to a DCM block size minimum.

A notional amount is calculated for each swap category to determine the minimum block size. The methodology used to calculate the relevant notional amount will be applied in two phases (except for equities, where no block trade treatment is afforded). For the first phase of implementation, market participants may reference Appendix F to Part 43, available [here](#), to view the minimum block size for each category of swap. Going forward, the CFTC will post minimum block sizes on its website and will review them at least annually.

Below is a table showing the applicable methodology underpinning the minimum block sizes during each of the two phases.

	<b><u>Initial Phase, underpinning Appendix F to Part 43</u></b>	<b><u>Post-Initial Phase, to be posted on the CFTC's website</u></b>
<b>Rates</b>	50% notional amount calculation	67% notional amount calculation
<b>Credit</b>	50% notional amount calculation	67% notional amount calculation
<b>FX</b>	Determined based on the block sizes set for related contracts by DCMs	67% notional amount calculation
<b>Equities</b>	No block trade treatment	No block trade treatment
<b>Other Commodities</b>	Determined based on the block sizes set for related contracts by DCMs	67% notional amount calculation

To calculate the minimum block size under the 50% notional amount calculation, the CFTC will generally set the minimum block size threshold at an amount such that 50% of the total notional amount of transactions in such category would not have been block trades. The 67% notional amount is calculated using the same methodology, but substituting 67% for the references to 50%.

As noted above, no equity swaps will receive block trade treatment. The CFTC reasoned that this was appropriate due to the existence of a highly liquid underlying cash market for equities; the absence of time delays for reporting block trades in the underlying equity cash market; the small relative size of the equity index swaps market relative to the futures, options, and cash equity index markets; and the CFTC's goal to protect the price discovery function of the underlying equity cash market and futures market.

Swap trades that occur off-exchange and have a notional amount above the minimum block size for that swap's respective category will receive block trade treatment.

Aggregation of orders to meet the block size requirement is permitted if trades are executed through a DCM or SEF by a person who is a commodity trading advisor, registered investment adviser, or foreign person performing a similar role, and that meets certain additional criteria, including having at least \$25 million in assets under management, but client consent is required.

The block trade rule also establishes block trade notional amount cap sizes for reporting. The purpose of the cap sizes is to anonymize the terms of the business transaction by masking high risk variables such as extreme notional amounts. Like the calculation for the notional amount for block size treatment, the notional amount for cap sizes will be implemented in a two-period, phased-in approach. The initial cap size will be set at the greater of: (i) interim cap sizes set forth in the final swap reporting rules (*i.e.*, for interest rate swaps with tenors of 0-2 years, \$250 million; for interest rate swaps with tenors of 2-10 years, \$100 million; and for interest rate swaps with tenors greater than 10 years, \$75 million; for credit swaps, \$100 million; for equity swaps, \$250 million; for foreign exchange swaps, \$250 million; and for other commodity swaps, \$25 million), or (ii) the appropriate minimum block size for the respective swap category. The post-initial cap size amount will apply a 75% notional amount calculation in the same manner as described above for the 67% notional amount calculation. Also, like minimum block sizes, cap sizes will be posted on the CFTC's website.

## Timing

The compliance date for market participants to execute Required Transactions exclusively via SEF or DCM will differ by swap, but will largely depend on the finalization of available-to-trade determinations. Specifically, compliance will be required by the later of (i) the applicable deadline for mandatory clearing of such swap under the CFTC's regulations, or (ii) 30 days after an available-to-trade determination for a given swap is approved or deemed effective. As described above, for an available-to-trade determination to be approved/deemed effective, a SEF/DCM must first submit the swap for CFTC approval and the CFTC must either approve the request or allow the certification to be deemed effective. Such event will trigger the 30 day countdown to mandatory SEF/DCM trade execution.

Initial minimum block sizes and cap sizes are effective on July 30, 2013. The initial period will last until the CFTC has collected one year of reliable swaps reporting data (expected to be approximately April 10, 2014) and will expire following the CFTC's publication of post-initial appropriate minimum block sizes and cap sizes. Post-initial block sizes and cap sizes will become effective on the first day of the 2nd month following the date of their publication.

## More Information

The relevant rules include:

- Core Principles and Other Requirements for Swap Execution Facilities, available [here](#);
- Process for a Designated Contract Market or Swap Execution Facility to Make a Swap Available-to-trade under Section 2(h)(8) of the Commodity Exchange Act (CEA); Swap Transaction Compliance and Implementation Schedule; Trade Execution Requirement Under Section 2(h) of the CEA, available [here](#); and
- Procedures to Establish Appropriate Minimum Block Sizes for Large Notional Off-Facility Swaps and Block Trades, available [here](#).

Please contact the Ropes & Gray attorney who usually advises you with any questions.