CFTC Finalizes SEF Rules and Adopts Minimum Block Trade Sizes

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On May 16, 2013, the CFTC adopted final rules relating to the registration and operation of swap execution facilities ("**SEFs**"), the Dodd Frank Act's mandatory trade execution requirement and the process for determining the threshold at which large swap transactions can qualify as "block trades." These rules include:

- the **SEF Rule**, which defines what types of trading platforms are required to register as SEFs, the core principles by which they must operate and the execution methods that can be used to satisfy the trade execution requirement in Section 2(h)(8) of the Commodity Exchange Act ("**CEA**");
- the **Made Available to Trade Rule**, which defines the procedures and criteria for determining that a swap that is required to be cleared is subject to the trade execution requirement; and
- the **Block Trade Rule**, which defines what large trades will be disseminated to the public on a delayed basis and would be exempt from certain trading rules.

This memorandum focuses on aspects of these rules of particular interest to dealers, asset managers and other swap counterparties.

The SEF Rule and the Made Available to Trade Rule will become effective on **August 5, 2013**. The Block Trade Rule will become effective on **July 30, 2013**. We discuss the compliance timing implications of these effective dates for market participants in greater detail below.

The SEF Rule

Section 2(h)(8) of the CEA 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." The CEA defines a SEF as 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 . . . and is not a designated contract market."

In keeping with this definition, the final SEF Rule requires that any trading system or platform that provides more than one market participant with the ability to execute or trade swaps with more than one other market participant must register as a SEF, unless it is registered as a DCM.

SEF Minimum Trading Functionality; Methods of Execution for Required Transactions

The SEF Rule defines a minimum trading functionality that all registered SEFs must offer and specifies execution methods that SEFs can offer to allow market participants to meet the CEA's trade execution requirement.

Minimum Trading Functionality—Order Book

A SEF must offer an order book for all swaps listed on the SEF. An order book is defined as:

- an electronic trading facility;
- a trading facility; or
- a trading system or platform in which all market participants can enter multiple bids and offers, observe bids and offers entered by other market participants, and transact on such bids and offers.

The SEF Rule does not impose any specific algorithm for matching participant bids and offers.

Time Delays for Order Book Trades

Brokers or dealers using an order book to execute against customer orders or to execute two customer orders against each other following some form of pre-arrangement or pre-negotiation of such orders are subject to a time delay between the entry of the two orders in the order book. According to the CFTC, the time delay is intended to disclose one side of the potential transaction and make it available to other market participants, before the second side of the potential transaction is submitted for execution. The rule provides for a default time delay of 15 seconds, but a SEF can adjust this if, based on a swap's liquidity or other product-specific characteristics, the SEF determines that a shorter time delay would allow market participants to have a meaningful opportunity to execute against the first order.

The time delay requirement currently applies only to brokers or dealers—and not to other traders—although the CFTC may revisit whether asset managers should also be subject to this requirement.

Minimum Execution Methods for Required Transactions

The CFTC refers to swap transactions subject to the trade execution requirement as "**Required Transactions**." Required Transactions, other than block trades in such swaps, as described below, must be executed on a SEF or DCM, and if executed on a SEF, must be executed using one of the "**Minimum Execution Methods**," which are:

- execution through an order book; or
- execution through an RFQ System, which is defined as a request for quote ("**RFQ**") facility that is operated in conjunction with an order book.

An RFQ System must allow market participants to transmit an RFQ to buy or sell a swap to no less than three market participants, none of which can be affiliated with the requester or with each other, subject to a one year phase-in period, during which an RFQ may be transmitted only to two other market participants. A SEF may choose whether the identity of the RFQ requester is or is not known to the RFQ recipients.

To satisfy the requirement that an RFQ facility for Required Transactions be "operated in conjunction with an order book," a SEF must provide the RFQ requester with any firm bid or offer for the same swap on any of the SEF's order books at the same time the requester receives the first responsive bid or offer. The RFQ requester must have the option and the ability to execute against the bids or offers in the order book along with responses to the RFQ, but is not required to execute against the order book bids or offers even if they are better than responses to the RFQ. The accompanying sidebar summarizes certain other key rules applicable to an RFQ System for execution of Required Transactions.

Other Key Rules Applicable to RFQ Systems

- After the initial RFQ, the requester may make a counter-request or offer, as long as it is submitted to at least three market participants. These need not be the same as the original RFQ recipients.
- The RFQ system may allow a transaction to be consummated if the original request to three potential counterparties receives fewer than three responses.
- A SEF must ensure 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. However, the CFTC does not specify what equal priority means in this context.

Permitted Transactions

A SEF may list and provide mechanisms for trading of swaps that are not Required Transactions, which are known as "**Permitted Transactions**." Permitted Transactions are not subject to the Minimum Execution Methods. However, SEFs must register with the CFTC even if they only list Permitted Transactions if they provide multiple-to-multiple trading in those swaps.

Other SEF Rules and Requirements

The SEF Rule establishes regulations, guidance and acceptable practices relating to the 15 core principles with which SEFs must comply as part of the conditions of registration. These 15 core principles are listed in the accompanying sidebar. We highlight below a few that are of particular interest to swap counterparties.

SEF Core Principles

1. Comply with SEF core principles.

2. Enforce compliance with all SEF rules.

3. Permit trading only in swaps not readily susceptible to manipulation.

4. Establish and enforce trading and trade monitoring procedures.

5. Facilitate information sharing with the CFTC.

6. Adopt position limits or position accountability rules as necessary.

7. Ensure the financial integrity of transactions.

8. Adopt rules enabling the exercise of emergency authority.

9. Make public timely swap trading information.

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Impartial Access

SEFs must provide all eligible contract participants ("**ECPs**") and independent Software Vendors ("**ISVs**"), such as aggregators, front-end trading software and smart order routing systems, with impartial access to their markets and market services—including any indicative quote screen and any similar pricing data displays. A SEF may not limit access to its trading systems or platforms to only certain types of ECPs or ISVs.

Access criteria must be impartial, transparent and applied in a fair and nondiscriminatory manner, and a SEF must charge comparable fees for participants receiving comparable access to, or services from, the SEF. SEFs must establish a process for confirming ECP status prior to SEF access being granted.

Among the factors that a SEF may consider as part of its access determination are applicants' disciplinary history and financial and operational soundness, as long as they are considered using objective, pre-established criteria.

SEF Core Principles (*cont'd.*)

10. Maintain comprehensive business records.

11. Avoid unreasonable restraints of trade.

12. Minimize conflicts of interest.

13. Maintain adequate financial resources to comply with all SEF requirements.

14. Maintain systems for minimizing operational risk.

15. Designate a Chief Compliance Officer.

Rule Enforcement Program

A SEF must establish and enforce trading, trade processing and participation rules that will deter abuses and establish and maintain the capacity to detect, investigate and enforce those rules. A SEF that permits intermediation must prohibit customer-related abuses including front-running, wash trading and pre-arranged trading (except for block trades), as well as fraudulent trading.

A SEF may adjust trade prices or cancel trades when necessary to mitigate market-disrupting events caused by malfunctions or errors, without the express consent of the counterparties. Any trade price adjustments or trade cancellations must be transparent to the market and subject to standards that are clear, fair and publicly available.

Data Protection Rules

A SEF may use proprietary or personal information obtained from the SEF's participants for business and marketing purposes, but only if the person from whom it collects the data clearly consents to the use of its information for those purposes.

Made Available to Trade Rule

Rule 40.5 Approval Process

- A SEF may request the CFTC's approval of a new rule prior to its implementation. The CFTC has 45 days to review the proposed rule, but may extend its review for another 45 days where novel or complex issues are present.

Rule 40.6 Self-Certification Process

- A SEF may submit a new rule to the CFTC under self-certification procedures. The CFTC has 10 business days to review the rule before it is deemed certified and can be made effective. However, the CFTC may stay certification for 90 days, during which time it must provide a 30-day public comment period.

As discussed above, a swap that is required to be cleared also will be subject to the Section 2(h)(8) trade execution requirement if a DCM or SEF makes the swap "available to trade." The Made Available to Trade Rule establishes a process for a SEF or DCM to designate a swap that is required to be cleared as made available to trade.

Under the Made Available to Trade Rule, a SEF or DCM will make the initial determination that a swap is available to trade and submit that determination to the CFTC under a rule approval process or a rule certification process, each of which is described in the accompanying sidebar.

The CFTC has stated that in the near term, it will only review made available to trade determinations for swaps subject to the mandatory clearing requirement and for which the submitting SEF or DCM lists the swap.

Factors to Consider in Determining Whether a Swap Is "Made Available to Trade"

In order to determine that a swap is made available to trade, a SEF or DCM must find that the swap meets one or more of the criteria listed in the rules, which include:

- whether there are ready and willing buyers and sellers;
- the frequency or size of transactions, and the trading volume, on SEFs or DCMs or of bilateral transactions;
- the number and types of market participants;

- the bid/ask spread; and
- the usual number of resting firm or indicative bids and offers.

Made available to trade determinations may be made for a group, category, type, or class of swap, although the SEF or DCM must demonstrate that the criteria are met for all swaps within the group, category, type, or class for which a determination is made. SEFs and DCMs may consider trading activity in the same swap on another SEF or DCM, or off-exchange.

The CFTC will identify those swaps that are made available to trade, and thus subject to the trade execution requirement, on its website. There is no procedure for removing a swap from the made available to trade list. Instead, the CFTC may issue a determination that a swap no longer has made available to trade status after all SEFs and DCMs have delisted the swap.

Compliance Timeline for the SEF Rule and Trade Execution Requirement

Prospective SEFs may apply to become registered SEFs prior to August 5, 2013, the effective date of the SEF Rule, so they can begin operating as a temporarily registered SEF beginning on the effective date. Temporarily registered SEFs can begin submitting made available to trade determinations for swaps that they list for trading and that are subject to the mandatory clearing requirement.

However, market participants will not be required to trade any swap on a SEF or DCM until *the later of* 30 days after the made available to trade determination for that swap is approved or deemed certified by the CFTC, and the date on which the counterparties to the swap are required to clear the swap. It is not yet clear how quickly potential SEFs will make made available to trade determinations, or how long it will take for such determinations to be approved or deemed certified by the CFTC.

Block Trade Rule

The Dodd-Frank Act, and the CFTC's related rules, provide special treatment to large notional size swap transactions that meet or exceed a minimum block trade size threshold, called "**block trades**" or "**large notional off-facility swaps**" depending on whether or not the trade is executed pursuant to the rules of a SEF or DCM. These terms are defined further in the accompanying sidebar.

First, a SEF trade that would otherwise have to be executed using one of the Minimum Execution Methods is exempt from that requirement if the trade is a block trade. A block trade can, for example, be pre-arranged and executed away from the SEF's order book.

Second, block trades and large notional off-facility swaps benefit from a delay in public dissemination of data about the trade under the CFTC's real-time reporting rules. The length of the delay, which will be phased in, varies depending on the counterparty type and whether or not the swap is subject

Block Trades and Large Notional Off-Facility Swaps

Part 43 defines a **block trade** as a publicly reportable swap transaction that:

- involves a swap that is listed on a registered SEF or DCM;
- occurs away from the registered SEF's or DCM's trading system or platform and is executed pursuant to the registered SEF's or DCM's rules and procedures;
- has a notional or principal amount at or above the specified minimum block size applicable to such swap; and
- is reported subject to the rules and procedures of the registered SEF or DCM and the real-time reporting rules in Part 43 of the CFTC's regulations.

A **large notional off-facility swap** is an off-facility swap that is publicly reportable, and has a notional or principal amount at or above the appropriate minimum block size applicable to that swap, and is not a block trade.

Current Cap Sizes

Until July 30, 2013, the following cap sizes will apply:

- CDS: $100M
- Equity: $250M
- FX: $250M
- Other commodities: $25M
- Caps on IRS vary by tenor:
  - 0-2 years: $250M
  - 2-10 years: $100M
  - 10+ years: $75M

Initial Period Cap Sizes

In the initial period, the caps on the notional volumes reported to the market will be the greater of the applicable minimum block size and the current cap size.

67% Methodology

The 67% methodology generally entails:

- ordering all publicly reportable swaps in the relevant category (excluding large outliers) by their notional amounts;
- determining the first swap for which 67% of the total notional amount of swaps in that category is comprised of swaps with a smaller notional size than that swap; and
- taking the notional size of the smallest such swap as the block threshold.

to mandatory clearing. For swaps subject to mandatory clearing involving at least one counterparty that is a swap dealer, the delay in the public dissemination of swap transaction data will ultimately be 15 minutes. **Appendix A** sets forth the delay periods.

The Block Trade Rule also establishes "cap sizes" for notional and principal amounts that will mask the total *actual notional* size of a swap transaction if it exceeds the cap size for a given swap category. The notional size of such a trade will be reported as larger than the cap size, rather than by its particular notional amount.

Implementation Timing and Block and Cap Calculation Methodology

The Block Trade Rule divides swap asset classes into categories, and assigns a minimum block trade size threshold and cap size to each category. For example, interest rate swaps are divided into categories based on nine tenors and three types of currencies, resulting in 27 swap categories. **Appendix B** summarizes the swap categories for each asset class.

Currently, public trade dissemination of all swaps is delayed *as if* they satisfied the minimum block trade size threshold and block status were elected. Starting on July 30, 2013, the effective date of the Block Trade Rule, the "**initial period**" minimum block trade size thresholds and cap levels will go into effect, and only swaps that have a notional amount at or above the appropriate minimum block trade size and for which block trade or large notional off-facility swap status is elected will receive the block treatment.

The initial period minimum block size thresholds are set forth in Appendix F of the Block Trade Rule and are available here. The cap sizes that currently apply and that will apply during the initial period are summarized in the accompanying sidebar.

Starting on April 10, 2014, the CFTC can announce that the initial period is over and that the "**post-initial period**" will begin. At that time, the CFTC will publish post-initial minimum block trade thresholds and cap sizes on its website, which will become effective on the first day of the second month following the date of publication. The CFTC will update these thresholds at least once per calendar year. SEFs and DCMs may set minimum block trade sizes for their markets at levels higher than the minimum size determined by the CFTC.

In several instances, the CFTC uses an "x% notional amount methodology" to calculate block trade size thresholds. In general, this means that the threshold is set at a level that would result in roughly x% of the total notional amount of swaps in that category that were transacted over a designated period ***not*** being treated as block trades. For example, the 67% notional amount methodology, which the CFTC will use to calculate the post-initial period minimum block trade size thresholds for all asset classes where block sizes are calculated, means that the threshold will be set at a level that would have resulted in roughly 33% of the total notional amount of swaps in that category being treated as blocks in the sample data set used.

The number of trades that would qualify for block treatment will depend heavily on the distribution of notionals in the category.

The implementation of minimum block trade size thresholds and cap sizes is summarized below.

	Blocks	Caps
Now until July 30, 2013	All trades treated as blocks	Current cap sizes listed in the sidebar on the previous page
Initial period	IRS and CDS use 50% methodology; other asset-class block sizes are as specified in the rule	Greater of the block size or current cap size
After initial period	67% methodology for all asset classes where block sizes are calculated (exceptions include FX transactions not involving super-major currencies, as defined in **Appendix B**, where all transactions are treated as blocks, and equity swaps which are not permitted to be treated as blocks regardless of size)	75% methodology for all asset classes

Election of Block Treatment

To benefit from block treatment, for a swap executed on a SEF or DCM, the parties must notify the SEF or DCM of their election to treat the swap as a block trade, and the SEF or DCM will notify the relevant swap data repository ("**SDR**") of the election when submitting data to the SDR. For a swap that is not traded subject to the rules of a SEF or DCM, the reporting party must notify the relevant SDR that the swap qualifies as a large notional off-facility swap at the time the swap is reported.

Block Aggregation, ECP Status, and Consent

The Block Trade Rule generally prohibits market participants from aggregating orders for different accounts in order to satisfy the minimum block trade size thresholds or to meet the cap size requirement. However, an exception is available where the aggregation is done on a DCM or SEF by a person that:

- has more than $25 million in total assets under management; and

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- meets one of a number of criteria relating to that person's representation of the underlying accounts, as described in the accompanying sidebar ("**Permitted Block Aggregator**").

Since the exception applies only where aggregation is done on a SEF or DCM, the aggregation rule appears to effectively prohibit the aggregation of orders for treatment as a large notional off-facility swap.

In addition, expanding on the general prohibition of executing swaps with non-ECPs other than on DCMs, parties to block trades must be ECPs; however, a DCM may allow a person who would qualify as a Permitted Block Aggregator to transact block trades for customers who are not ECPs.

Finally, a person transacting a block trade on behalf of a customer must receive prior written instruction or consent from the customer to do so. The written instruction or consent can be in the form of a power of attorney or similar document that provides discretionary trading authority. However, the instruction or consent to trade in blocks must be explicit—a general grant of investment discretion or notice is not sufficient.

Permitted Block Aggregators

Aggregation of orders for different accounts is available only where the aggregation is done on a DCM or SEF by a person that has more than $25 million in total assets under management and is:

- a commodity trading advisor registered that is registered with the CFTC or exempt from such registration, or a principal thereof, and who has discretionary trading authority or directs client accounts;
- an investment adviser (a) that has discretionary trading authority or directs client accounts; (b) is registered under the Advisers Act of 1940 or under state law; and (c) has been registered and active for two years, *or* provides security investment advice to securities accounts that, in the aggregate, have total assets in excess of $5,000,000 deposited at one or more registered securities brokers; or
- a foreign person that performs a similar role or function as the persons described above and is subject as such to foreign regulation.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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Appendix A: Public Dissemination Delay for Block Trade / Large Notional Off-Facility Swap Reporting

The Real-Time Reporting Rule under CFTC Part 43 provides the following time delays for block trades and large notional off-facility swaps.

Where an SD/MSP Counterparty Is the Regulatory Reporting Party

SWAP CHARACTERISTICS	TIME DELAYS FOR PUBLIC DISSEMINATION*		
	Year 1	Year 2	Year 3 and Thereafter
Executed On or Pursuant to the Rules of a Registered SEF or DCM	30 minutes	15 minutes	15 minutes
Off-Facility, Subject to Mandatory Clearing	30 minutes	15 minutes	15 minutes
Off-Facility, Not Subject to Mandatory Clearing	Credit, equity, foreign exchange** and interest rate swaps: 1 hour Other commodity swaps: 4 hours	Credit, equity, foreign exchange** and interest rate swaps: 30 minutes Other commodity swaps: 2 hours	Credit, equity, foreign exchange** and interest rate swaps: 30 minutes Other commodity swaps: 2 hours

* Delays are measured from the execution of the swap. Years are measured from the reporting compliance date.

** FX swaps and deliverable FX forwards are not subject to the real-time reporting requirement under CFTC Part 43, pursuant to the Treasury Secretary's Determination dated November 12, 2012 for FX swaps and deliverable FX forwards. See Davis Polk's Client Newsflash, available here.

Where a non-SD/MSP Counterparty Is the Regulatory Reporting Party

SWAP CHARACTERISTICS	TIME DELAYS FOR PUBLIC DISSEMINATION*		
	Year 1	Year 2	Year 3 and Thereafter
Executed On or Pursuant to the Rules of a Registered SEF or DCM	30 minutes	15 minutes	15 minutes
Off-Facility, Subject to Mandatory Clearing	4 hours	2 hours	1 hour
Off-Facility, Not Subject to Mandatory Clearing	48 business hours	36 business hours	24 business hours

* Delays are measured from the execution of the swap. Years are measured from the reporting compliance date.

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Appendix B: Block Categories by Asset Class and Block Calculation Methodology

Block Swap Category	Swap Category Division Method	Block Size Methodology In Effect Starting July 30, 2013	Post-initial Period Block Size Methodology*
IRS	9 tenor groups x 3 currency groups (27 total categories)	50% notional methodology	67% notional methodology
CDS	6 tenor groups x 3 spread groups (18 total categories)	50% notional methodology	67% notional methodology
Equity	Single category	No blocks	No blocks
FX	Super-major currency (USD, EUR, GBP, JPY) with: – **another super-major currency** (6 categories) – **each of 9 major currencies** (AUD, CAD, CHF, DKK, KRW, SEK, NOK, NZD, ZAR) (36 categories) – **each of the currencies of** Brazil, China, Czech Republic, Hungary, Israel, Mexico, Poland, Russia or Turkey (36 categories) **All other currency combinations grouped in a single category (e.g., CAD/AUD) are treated as a block trade, both in the initial period and in the post-initial period	Set by reference to futures contracts; see tables in the appendix to the rule.	67% notional methodology (where block sizes are calculated; FX transactions not involving super-major currencies are all treated as blocks)
Other Commodities	Grouped based on “economically related” trades in tables published by the CFTC	Set by reference to futures contracts; see tables in the appendix to the rule	67% notional methodology (where block treatment is available)

* The post-initial thresholds will become effective on the first day of the second month following the date the CFTC publishes the post-initial period minimum block trade sizes on its website. The Block Trade Rule provides that the CFTC can publish the post-initial period minimum block trade sizes any time on or after April 10, 2014. Thereafter, the CFTC will update these thresholds at least once per calendar year.