

# Designing Your SEF Compliance Program

*Compliance in a Changing Market*

Stephen M. Humenik  
Covington & Burling LLP  
Washington, DC  
April 21, 2016



# Upcoming L&C Webinars and Events



## **38th Annual FIA Law & Compliance Conference**

May 4-6, 2016 | Baltimore Waterfront Marriott | Baltimore, MD



## **Margin Regulations: CFTC, Prudential Regulators, SEC and the EU**

May 26, 2016 | 10:00 AM ET | Webinar

Presenter: Peter Malyshev of Reed Smith



## **Anti-evasion**

June 16, 2016 | 10:00 AM ET | Webinar

Presenter: Stacy Hartman of Schiff Hardin

Registration coming soon!

Learn more and register at [FIA.org/lc](http://FIA.org/lc)



# Administrative Items

The webinar will be recorded and posted to the FIA website following the conclusion of the live webinar.

A question and answer period will conclude the presentation.

- Please use the “question” function on your webinar control panel to ask a question to the moderator or speakers. Questions will be answered at the conclusion of the webinar.

CLE certificates will be emailed shortly after conclusion of the webinar.





# Your Presenter

---



## **Stephen M. Humenik**

Of Counsel

Washington, DC

+1 202 662 5803

[shumenik@cov.com](mailto:shumenik@cov.com)

Stephen Humenik leads Covington's futures and derivatives practice. He has extensive experience on cross-border regulatory, compliance and enforcement matters involving the U.S. Commodity Futures Trading Commission (CFTC) and markets for derivatives and physical and financial commodities. Mr. Humenik applies his business, operational, and technology experience to the implementation of CFTC regulations. Specifically, he advises clients, including financial institutions, asset managers, and end-users, on regulatory and policy matters relating to the registration, trading, clearing and other compliance obligations of the Dodd-Frank Act. Mr. Humenik also represents clients in CFTC enforcement investigations and proceedings. Prior to joining Covington, Mr. Humenik was general counsel and chief regulatory officer of an interest rate swap derivatives market, where he oversaw the legal and regulatory affairs of the exchange, including the exchange's designation as a contract market and ongoing compliance with CFTC regulations. Mr. Humenik previously served as Special Counsel and Policy Advisor to former CFTC Commissioner Scott O'Malia where he assisted on rulemaking, enforcement and legislative matters. Mr. Humenik began his career at the CFTC and primarily served as Senior Trial Attorney for the CFTC's Division of Enforcement where he investigated and litigated complex fraud and market manipulation cases, specifically those involving financial and energy derivatives and physical commodities. Mr. Humenik received his J.D. from the Catholic University of America, Columbus School of Law and B.A. from Pennsylvania State University.

# Overview

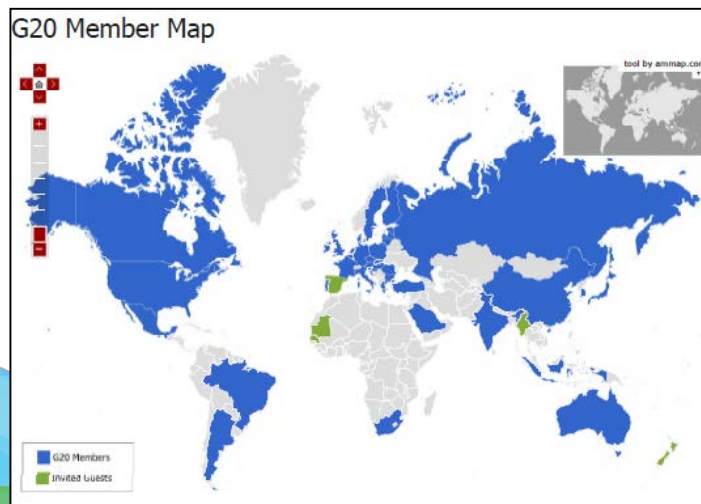
- Swaps Trading Before and after Dodd-Frank
- Swaps Trading Venues: SEFs
- The Trading Mandate and Execution Methods
- The Current SEF Environment
- Compliance Assessment of SEF Core Principles
- Common Key SEF Rules
- Key Differences Among SEF Rules
- The Future: Rule Enforcement Reviews

# The Swaps Market Prior to the Dodd-Frank Act

- The word “swap” appeared in the Commodity Exchange Act (CEA) only 4 times prior to Dodd-Frank.
- Swaps were not subject to comprehensive regulation by the CFTC.
- Over-the-counter, bilateral market.
- Swaps were traded over the phone, voice, instant message, and on electronic platforms.
- Swaps were documented between counterparties using ISDA template documents. ISDAs were needed for bilateral relationships and based on counterparty credit (\*ISDAs are still needed post-Dodd-Frank for uncleared transactions).
- Limited clearing of swaps.
- Diversity of collateral for swaps activity. Cash margin not required.
- Bilateral trading still exists for certain products, post-Dodd-Frank.

# The Financial Crisis: International Reaction

- In September 2009 the leaders of the Group of 20 (G-20)—whose membership includes the United States, the European Union, and 18 other countries—agreed to a five part framework for global OTC derivatives reform:
  - Central clearing of OTC derivatives;
  - Increased standardization of OTC derivatives;
  - **Exchange trading of standardized derivatives;**
  - Reporting derivatives trades to trade repositories, and
  - Increased capital requirements for non-cleared derivatives



Argentina	Japan
Australia	Republic of Korea
Brazil	Mexico
Canada	Russia
China	Saudi Arabia
France	South Africa
Germany	Turkey
India	United Kingdom
Indonesia	United States
Italy	European Union

# Dodd-Frank Building Blocks

Clearing

Swap Dealer Oversight

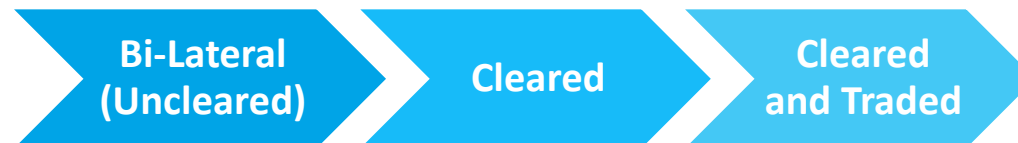
Pre/Post-Price Transparency

**Swaps Market Reform –  
Reduction of Systemic Risk**

Central clearing is **one of the three major building blocks of Dodd-Frank swaps market reform** -- in addition to **promoting market transparency** and bringing swap dealers under comprehensive oversight -- and this rule completes the clearing building block.

- Central clearing lowers the risk of the highly interconnected financial system. It also democratizes the market by eliminating the need for market participants to individually determine counterparty credit risk, as now clearinghouses stand between buyers and sellers.
- In a cleared market, more people have access on a **level playing field**.
- Small and medium-sized businesses, banks and asset managers can **enter the market and trade anonymously and benefit from the market's greater competition**.

**Chairman Gensler, November 28, 2012 (Statement on Clearing Determinations).**





# Swap Trading Venues

- Dodd-Frank introduced concept of trading swaps on trading platforms, and created a new type of trading venue: the Swap Execution Facility or SEF:
- Swap Execution Facility (SEF)
  - Any trading facility, that facilitates the execution of swaps between persons and is not a DCM
  - 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
- Designated Contract Market (DCM)
  - Boards of trade (or exchanges) that operate under the regulatory oversight of the CFTC
  - Traditional futures exchanges: CME, NYMEX, ICE Futures, Nodal
  - Can offer the trading of futures and swaps

# Swap Execution Facilities

- Section 733 of the Dodd-Frank Act (codified as Section 5h(e) of the CEA) states “[t]he goal...is to promote the trading of swaps on swap execution facilities and to promote pre-trade price transparency in the swaps market”.
- Additionally, Congress defined Swap Execution Facility 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, 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”. (7 USC 1a (50))

# The Swaps Trading Mandate

- Per CFTC Regulations, a DCM or SEF may make a swap available to trade by submitting a request for Commission approval of a new rule or a certification of a new rule's compliance with the Core Principles.
- A swap that is made available to trade must be traded on a SEF or DCM – a transaction in such a swap is a “Required Transaction.” Any other transaction is a “Permitted Transaction.”
- The MAT Process is under review by the industry and CFTC; some have proposed a modification of the process to allow greater role for CFTC to determine MAT products.
- Factors to be considered by a SEF or DCM when determining whether to make a swap available to trade. The factors, with respect to a swap are:
  1. Whether there are ready and willing buyers and sellers;
  2. The frequency or size of transactions on SEFs, DCMs, or of bilateral transactions;
  3. The trading volume on SEFs, DCMs, or of bilateral transactions;
  4. The number and types of market participants;
  5. The bid/ask spread;
  6. The usual number of resting firm or indicative bids and offers
  7. Whether a SEF or DCM's trading system or platform will support trading in the swap; or
  8. Any other factor that the SEF or DCM may consider relevant.

# Trade Execution Methods

§ 37.9 Methods of execution for required and permitted transactions.

(a) Execution methods for required transactions.

(1) Required transaction means any transaction involving a swap that is subject to the trade execution requirement in section 2(h)(8) of the Act.

(2) Execution methods.

(i) Each Required Transaction that is not a block trade as defined in section 43.2 of this chapter shall be executed on a swap execution facility in accordance with one of the following methods of execution:

(A) An Order Book as defined in section 37.3(a)(3); or

(B) A Request for Quote System, as defined in paragraph (a)(3) of this section, that operates in conjunction with an Order Book as defined in section 37.3(a)(3).

# Trade Execution Methods

## § 37.9 Methods of execution for required and permitted transactions.

(ii) In providing either one of the execution methods set forth in paragraph (a)(2)(i)(A) or (B) of this section, a swap execution facility may for purposes of execution and communication use any means of interstate commerce, including, but not limited to, the mail, internet, email, and telephone, provided that the chosen execution method satisfies the requirements provided in section 37.3(a)(3) for Order Books or in paragraph (a)(3) of this section for Request for Quote Systems.

## § 37.9(a)(3) Order book means:

- (i) An electronic trading facility, as that term is defined in section 1a(16) of the Act;
- (ii) A trading facility, as that term is defined in section 1a(51) of the Act; or
- (iii) A trading system or platform in which all market participants in the trading system or platform have the ability to enter multiple bids and offers, observe or receive bids and offers entered by other market participants, and transact on such bids and offers.

# Trade Execution Methods

§ 37.9 Methods of execution for required and permitted transactions.

(3) Request for quote system means a trading system or platform in which a market participant transmits a request for a quote to buy or sell a specific instrument to no less than three market participants in the trading system or platform, to which all such market participants may respond. The three market participants shall not be affiliates of or controlled by the requester and shall not be affiliates of or controlled by each other. A swap execution facility that offers a request for quote system in connection with Required Transactions shall provide the following functionality:

(i) At the same time that the requester receives the first responsive bid or offer, the swap execution facility shall communicate to the requester any firm bid or offer pertaining to the same instrument resting on any of the swap execution facility's Order Books, as defined in section 37.3(a)(3);

(ii) The swap execution facility shall provide the requester with the ability to execute against such firm resting bids or offers along with any responsive orders; and

(iii) The 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.

# Trade Execution Time Delay

(b) Time delay requirement for required transactions on an order book.

(1) Time delay requirement. A swap execution facility shall require that a broker or dealer who seeks to either execute against its customer's order or execute two of its customers' orders against each other through the swap execution facility's Order Book, following some form of pre-arrangement or pre-negotiation of such orders, be subject to at least a 15 second time delay between the entry of those two orders into the Order Book, such that one side of the potential transaction is disclosed and made available to other market participants before the second side of the potential transaction, whether for the broker's or dealer's own account or for a second customer, is submitted for execution.

# The Current SEF Environment

- The CFTC recently granted full registration to 18 SEFs in January 2016

SEF	Rates	Credit	FX	Commodities	Equity
360 Trading Networks, Inc.			•		
BGC Derivatives Markets, L.P.	•	•	•	•	•
Bloomberg SEF LLC	•	•	•	•	•
Chicago Mercantile Exchange, Inc.				•	
DW SEF LLC	•				•
GFI Swaps Exchange LLC	•	•	•	•	•
ICAP Global Derivatives Limited	•	•			
ICAP SEF (US) LLC	•	•	•	•	•
ICE Swap Trade LLC		•		•	
Javelin SEF, LLC	•				
LatAm SEF, LLC	•		•		
MarketAxess SEF Corporation		•			
SwapEx LLC	•		•		
Thomson Reuters (SEF) LLC			•		
tpSEF Inc.	•	•	•	•	•
Tradition SEF, Inc.	•	•	•	•	•
trueEX LLC	•				
TW SEF LLC	•	•			



# SEF Trading Volumes Vary

SEF	Rates	Credit	FX
360 Trading Networks, Inc.			
BGC Derivatives Markets, L.P.	•		•
Bloomberg SEF LLC	•	•	•
Chicago Mercantile Exchange, Inc.			
Clear Markets North America, Inc.			
DW SEF LLC			
GFI Swaps Exchange LLC			•
GTX SEF LLC			
ICAP Global Derivatives Limited	•		
ICAP SEF (US) LLC	•		•
ICE Swap Trade LLC			
Javelin SEF, LLC			
LatAm SEF, LLC			
MarketAxess SEF Corporation			
SwapEx LLC			
TeraExchange, LLC			
Thomson Reuters (SEF) LLC			
tpSEF Inc.	•		•
Tradition SEF, Inc.	•		•
trueEX LLC			
TW SEF LLC	•	•	

Bullet point represents a market share of 4% or more per FIA SEF Tracker dated January 2016



# SEF Core Principles

- CFTC has promulgated 15 SEF Core Principles in 17 C.F.R. Part 37
- Guidance on SEF Core Principles is in 17 C.F.R. Part 37, Appendix B
- Core Principles are the building blocks of a SEF Rulebook – familiarity with Core Principles will assist in building a compliance program with SEF Rules – both for the SEFs and market participants.

# SEF Core Principles: Compliance Evaluation

CORE PRINCIPLES FOR SEFs	EVALUATION MEASURE
<b>(1) Compliance with Core Principles</b>	Review of SEF Rulebook and other available documentation to test compliance and completeness.
<b>(2) Compliance with Rules</b>	Review of all connected SEF Rulebooks for comparative analysis, which informs overall compliance measures and testing.
<b>(3) Swaps Not Readily Susceptible to Manipulation</b>	Review of swap contract specifications and underlying methodology per CFTC Guidance in Appendix C of DCM Core Principles.
<b>(4) Monitoring of Trading and Trade Processing</b>	Review rules or procedures related to order processing and matching algorithms.
<b>(5) Ability to Obtain Information</b>	Review scope of documents SEF can request from participant.
<b>(6) Position Limits or Accountability</b>	Review platform based position limit controls; consider how platforms or CFTC may aggregate platform activity.
<b>(7) Financial Integrity of Transactions</b>	Review policies related to connectivity to DCO and pre-trade credit checks.
<b>(8) Emergency Authority</b>	Review procedures and participate (or obtain results) of industry-wide testing.

# SEF Core Principles: Compliance Evaluation

CORE PRINCIPLES FOR SEFs	EVALUATION MEASURE
<b>(9) Timely Publication of Trading Information</b>	Review of publicly available information and diligence regarding scope of disclosure and licensing of market data.
<b>(10) Recordkeeping And Reporting</b>	Review SEF Rules to demonstrate compliance with recordkeeping rules, specifically related to order routing. Test compliance to demonstrate effectiveness of reporting by SEF to SDR.
<b>(11) Antitrust Considerations</b>	Review ownership structure, SEF committees and other considerations.
<b>(12) Conflicts of Interest</b>	Review conflicts of interest policies and board structure.
<b>(13) Financial Resources</b>	Request summary financial information filed with CFTC to evaluate viability and cost/benefit analysis of connecting to SEF.
<b>(14) System Safeguards</b>	Review summary of SEF technology operations and controls.
<b>(15) Designation of Chief Compliance Officer</b>	Review background of SEF CCO; request information related to Annual CCO compliance report in absence of rule enforcement review.

# Compliance with SEF Rules

- Execution Methods of Required Transactions
  - Required Transactions must only be executed via Order Book or Request-For-Quote.
  - An RFQ for a Required Transaction must be transmitted to at least 3 other unaffiliated market participants.
- Access to a SEF
  - Only “Eligible Contract Participants” may effect a transaction on a SEF
  - Determine ECP status when onboarding Customers who will have any form of access to the SEF (direct market access, sponsored access, etc.).
- Pre-Execution Discussions/Pre-Arrangement/Cross-Trades
  - Each of these types of trades must be exposed on the order book for 15 seconds before execution if a Required Transaction.
  - However, SEF rules regarding these trades vary.

# Compliance with SEF Rules

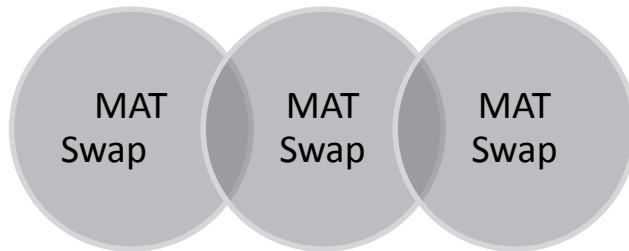
- Client Orders
  - Client orders must be kept confidential, except in certain circumstances (disclosure to SEF, disclosure to CFTC)
  - Client orders must be entered in the sequence received, and you may not trade ahead of client orders.
- Clearing Rejections
  - Procedures for clerical or operational areas
  - Void *ab initio* procedures
  - SEF Rulebooks defer to Clearing House rules
- Block Trades
  - Before entering a block trade with a customer, must obtain that customers consent
  - Price of a block trade must be “on market”
  - Generally not allowed to aggregate orders for different accounts to meet minimum threshold
- Focus on Liquidity Provider Agreements
- Fees compared to other market participants will be reviewed

# Compliance with SEF Rules

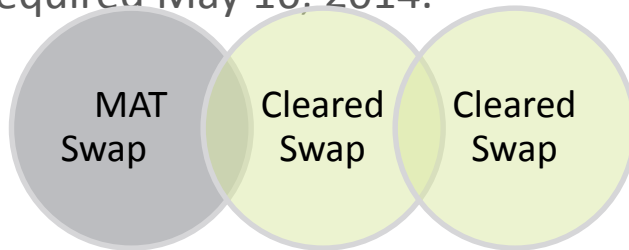
- Package Transaction
  - A package transaction is a transaction involving two or more instruments:
    - that is executed between two or more counterparties;
    - that is priced or quoted as one economic transaction with simultaneous or near simultaneous execution of all components;
    - that has at least one component that is a swap that is made available to trade and therefore is subject to the CEA section 2(h)(8) trade execution requirement; and
    - where the execution of each component is contingent upon the execution of all other components.
- Package Transactions have been the topic of much industry discussion, including a public roundtable at the CFTC, as there is a debate around whether the technology exists to facilitate exchange trading of packages or at least the legs of a package that are subject to the trading mandate.

# Compliance with SEF Rules

- CFTC most recently issued relief on October 14, 2015 from mandatory exchange trading of package transactions, which has been and continues to be phased-in as follows:



- For package transactions in which all components are swaps subject to the trade execution requirement, there is no additional relief, so compliance was required May 16, 2014.

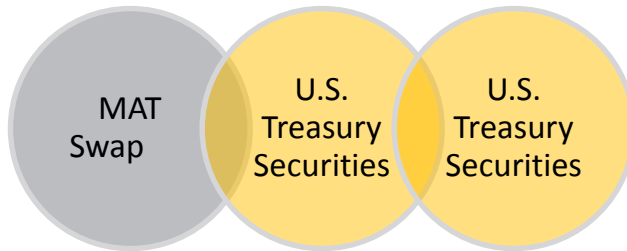


- For package transactions in which the components include at least one swap component that is subject to the trade execution requirement and all other components are swaps subject to the mandatory clearing requirement, relief is provided until June 2, 2014.

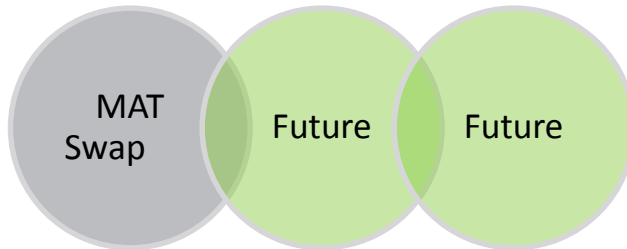


# Compliance with SEF Rules

- Phase-in (cont'd):



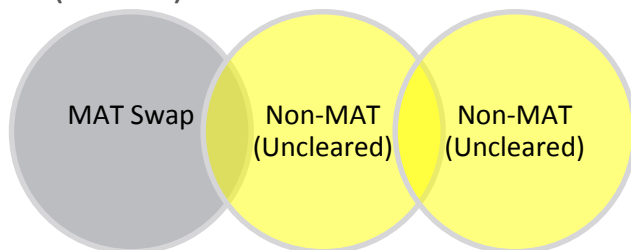
- For package transactions in which the swap components are subject to the trade execution requirement and all other components are U.S. Treasury securities (U.S. Dollar Swap Spreads), relief is provided until June 16, 2014.



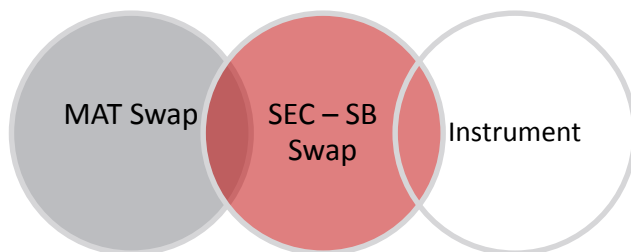
- For package transactions (excluding U.S. Dollar Swap Spreads) in which the components include at least one individual swap component that is subject to the trade execution requirement and all other components are futures, relief is provided until November 15, 2016 (i.e., for example MAT Swap/Futures).

# Compliance with SEF Rules

- Phase-in (cont'd):



- For package transactions in which the components include at least one swap component that is subject to the trade execution requirement and at least one swap component that is under the Commission’s exclusive jurisdiction and not subject to the clearing requirement, relief is provided until November 15, 2016 (i.e., MAT swap v. uncleared credit default swap).



- For package transactions in which the components include at least one swap component that is subject to the trade execution requirement and at least one swap component that is a swap over which the Commission does not have exclusive jurisdiction, relief is provided until November 15, 2016.

# Compliance with SEF Rules

- Manipulative trading prohibited
  - Knowingly or recklessly engaging false or fraudulent activity, making materially false or misleading statements, or any other attempt to manipulate the price of a swap.
- Disruptive trading prohibited
  - Violating bids or offers
  - Banging the close
  - Spoofing

# Common SEF Rules

- “Catch All” Rules
  - Prohibition on “engaging in any behavior that is detrimental to the SEF or the reputation of the SEF.”
- Trade Confirmations for Uncleared Swaps
  - SEF reflects the terms of an uncleared swap in a Trade Communication sent to the market participants
  - Trade Communication, and other documents and agreements (ISDA masters, term supplements, etc.) governing swap (Terms Incorporated by Reference) comprise the terms of the transaction and serve as confirmation.
  - Trade Communication governs over Terms Incorporated by Reference

# SEF Rule Variations

- Although many rules are common across SEFs, there remain many key differences among SEF Rulebooks.
- Conduct that is acceptable when trading on one SEF may be a violation when trading on another SEF and lead to sanctions.
- SEF rules vary with regard to:
  - Treatment of Permitted Transactions
  - Requirements for pre-execution discussions and pre-arrangement
  - Cross-trades
  - Errors, Cancellations, and Trade Busts

# SEF Rule Variations – Permitted Transactions

- Permitted Transactions
  - Many rules applicable to Required Transactions may not be applicable to Permitted Transactions – however which rules do not apply and under what conditions varies.
  - Examples (based on review of available documents):
    - ICAP SEF explicitly exempts Permitted Transactions from prohibition on pre-arranged trading.
    - tpSEF does not allow pre-arranged trading for “Permitted Transactions,” but does allow for Permitted Cross Transactions.
    - TrueEX LLC allows pre-arrangement of Permitted Transactions, but trade must be verified on SEF within 15 minutes and must be cleared.

# SEF Rule Variations – Pre-Execution Discussions/ Pre-Arrangement

- Pre-Execution Discussions and Pre-Arrangement
  - Types of transactions that may be executed after pre-execution discussion or pre-arrangement, and under what conditions, varies.
  - Examples (based on review of available documents):
    - Market Axess does not allow pre-execution communications or pre-arrangement for Order Book trades.
    - tpSEF does not allow pre-arrangement, and only allows pre-execution communication for cross-trades that are Permitted Transactions.

# SEF Rule Variations – Cross-Trades

- Cross-Trades: non-competitive trades between two customers, or between a participant and customer.
- May be different requirements for cross-trades between two customers, and between participant and customer.
- Examples (based on review of available documents):
  - Tradition SEF requires customer's written consent before participant may take the other side of a customer's order as an exception to trading against a customer order.
  - Market Axess does not allow a participant to take the other side of a customer's order under any circumstance, but does allow cross-trades between two customers.



# SEF Rule Variations – Errors and Trade Cancellations

- Each SEF has a process for reviewing alleged errors and cancelling trades.
- Differences among SEFs in when they will cancel trades (i.e. no-bust range), time frame, and ability of parties to resolve the issue by agreement.
- Examples (based on review of available documents):
  - TW SEF and DW SEF will consider cancelling any trade, they have no no-bust range.
  - Bloomberg SEF will not cancel a trade that is within 30% of the prior day's settlement price.
  - GAIN GTX requires request to review be made 1 business day, while ICE requires the request be made within 8 minutes.
  - TrueEX and GFI Swaps Exchange allow parties to mutually agree to resolution, many other SEFs do not address the issue.

# The Early Days of SEF Enforcement

- SEFs have been monitoring market activities, but have yet to take formally announced disciplinary actions.
- SEFs are now SROs and the CFTC will closely coordinate with SEFs.
- To date, most SEFs have followed up on exception reports.
- Few SEFs have issued warning letters.
- Typically, a market participant can only get one warning letter a year.

# Coming Soon – SEF Rule Enforcement Reviews

- Rule Enforcement Reviews, and the reports prepared by the Division of Market Oversight (“DMO” or the “Division”), are intended to present an analysis of an exchange’s compliance capabilities during the period under review.
- Such reviews to date have only dealt with exchanges (DCMs).
- The RERs assess certain compliance programs and do not assess all programs, core principles, or Commission regulations.
- Deficiency v. Recommendation
  - a deficiency is an area where DMO believes an exchange is not in compliance with a Commission regulation and must take corrective action
  - a recommendation concerns an area where DMO believes the exchange should improve its compliance program

# Recent Rule Enforcement Review Deficiencies

- Sample deficiencies from recent reviews:
  - Inadequate staffing to conduct investigations or prosecute possible rule violations.
  - Penalties were insufficient to deter rule violations.
  - In recent review, penalty of \$500-\$750 per rule violation was not enough.
  - Program for reviewing audit trail data was not effective.
  - Reviewing annual certifications from clearing firms and occasional randomly selected samples of audit trail data is not enough.
  - Investigations were not completed promptly.
  - Some took longer than a year, in violation of CFTC Regulation 38.158(b).

# Summary

- The building blocks of a SEF compliance program:
  - Review of CEA and CFTC rules
  - Review of SEF rulebooks and updates
  - Identification of similarities and differences among SEFs
  - Implementing changes based on regulatory and enforcement developments

# Questions?

Please use the “question” function on your webinar control panel to ask a question to the moderator or speakers.

For more information please contact:

Stephen Humenik, [shumenik@cov.com](mailto:shumenik@cov.com)



# Disclaimer

This presentation is not intended as legal advice. You should seek specific legal advice before acting with regard to the subjects mentioned herein.

© Copyright 2016 Covington & Burling LLP. All Rights Reserved

