From:	Sturgeon, Linda J <Linda.Sturgeon@skadden.com> on behalf of Young, Mark D <Mark.D.Young@skadden.com>
Sent:	Wednesday, September 22, 2010 4:32 PM
To:	SEFRules <SEFRules@CFTC.gov>
Subject:	SEF Registration Requirements and Core Principle Rulemaking, Interpretation & Guidance
Attach:	Document.pdf

Mr. Stawick,
Please find attached our comments re Interpretation of Statutory Registration Requirements for Swap Execution Facilities and Security-Based Execution Facilities.
Thank you for your consideration.

Linda J. Sturgeon
Assistant to Mark D. Young and Prashina Gagoomal
Skadden, Arps, Slate, Meagher & Flom LLP
1440 New York Avenue, N.W. | Washington | D.C. | 20005-2111
T: 202.371.7601
linda.sturgeon@skadden.com

SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP

1440 NEW YORK AVENUE, N.W.
WASHINGTON, D.C. 20005-2111

TEL: (202) 371-7000
FAX: (202) 393-5760
www.skadden.com

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SYDNEY
TOKYO
TORONTO
VIENNA

DIRECT DIAL
202-371-7680
DIRECT FAX
202-661-0580
EMAIL ADDRESS
MARK.D.YOUNG@SKADDEN.COM

September 22, 2010

David A. Stawick, Secretary
U.S. Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Elizabeth M. Murphy, Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Interpretation of Statutory Registration Requirements for Swap Execution Facilities and Security-Based Swap Execution Facilities

Dear Mr. Stawick and Ms. Murphy:

The leadership of the Commodity Futures Trading Commission (CFTC) and Securities and Exchange Commission (SEC) have requested public comments to be filed with the agencies on issues of importance arising under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank" or the "Act"). Most recently, the agencies published a more formalized request for comments in a variety of areas in the Federal Register. *See* Acceptance of Public Submissions on the Wall Street Reform and Consumer Protection Act and the Rulemakings That Will Be Proposed by the Commission, 75 Fed. Reg. 52512 (Aug. 26, 2010). One of the identified areas of interest and eventual rulemaking concerned "Swap Execution Facilities" (SEFs) and "Security-Based Swap Execution Facilities" (SBSEFs). *Id.* at 52513.

In the short time since passage of the Act, many public conferences have been conducted explaining and analyzing the Act's provisions. In these meetings, one issue that is often raised and debated is the proper scope of the Dodd-Frank registration requirement for SEFs and SBSEFs. Specifically, the issue is whether facilities that do not provide for execution of swaps, but simply process in some way already executed swaps, must register as a SEF or SBSEF.

Given the vital role registered SEFs and SBSEFs will play in achieving the Act's objectives, the SEF/SBSEF registration issue is precisely the kind of important statutory interpretation issue on which we expect the agencies would welcome public comment. We offer the following views on the SEF/SBSEF registration requirement because this issue affects a number of our clients, although this letter is not being submitted on behalf of any specific client.

Dodd-Frank and SEFs/SBSEFs: Registration and Definition

Dodd-Frank contains four basic SEF and SBSEF provisions – a definition, a registration requirement, a series of core principles to be met and the exchange-trading mandate for clearable swaps. In basic outline, the Act requires SEFs and SBSEFs to register with the CFTC or SEC respectively, to comply with self-regulatory core principles and to decide whether to trigger the exchange-trading mandate for clearable swaps by making swaps available for trading, as the SEF or SBSEF believes to be appropriate.

The SEF/SBSEF provisions flow out of the statutory definition of a SEF/SBSEF and the registration requirement. The Act defines SEF without any reference to "processing" of swaps. Under Dodd-Frank, the term "SEF" 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.[1]

This definition focuses exclusively on "the ability" of market participants to "execute or trade" swaps through a system or platform.

The Dodd-Frank registration requirement, however, provides: "[n]o person shall 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."[2] Dodd-Frank does not define the terms "facility," "trading" or "processing." Nonetheless, a processing facility is quite different from an execution facility. An execution facility is where bids and offers for swap transactions can be

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[1] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Congress, § 721 (2010) (enacted) [hereinafter "Act"]. A SBSEF is defined similarly as, "a trading system or platform in which multiple participants have the ability to execute or trade security-based 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 security-based swaps between persons; and (B) is not a national securities exchange." *See* Act § 761.

[2] *See* Act § 733. Similarly, "[n]o person may operate a facility for the trading *or* processing of security-based swaps, unless the facility is registered as a security-based swap execution facility or as a national securities exchange." *See* Act § 763 (emphasis added).

made and accepted, resulting in the swap having been "traded or executed." A processing facility reconciles, records and otherwise documents swaps that have already been offered to be entered into (e.g. traded) or entered into (e.g. executed).[3] Not surprisingly, the statutory title of the regulatory category Congress created – SEF (or SBSEF) – itself emphasizes the "execution" capacity of the facility. Congress did not call these entities "Swap Execution or Processing Facilities."

Under basic principles of statutory construction, "if a statute defines a term in its definitional section, then that definition controls the meaning of the term *whenever* it appears in the statute."[4] The absence of the term "processing" in the statutory definition of SEF/SBSEF is thus significant and should affect the construction of all statutory references to SEF/SBSEF, including the requirement that trading or processing facilities register as SEFs/SBSEFs. When the registration requirement is not read in light of the statutory SEF/SBSEF definition, an absurd situation – and one that Congress would not have intended – arises: a person could be required to register in a statutorily-defined category although that person does not meet the statutory definition for that category.

To avoid this contradictory result, we believe that the CFTC and the SEC should adopt an approach that would harmonize the SEF/SBSEF definition and registration requirement by interpreting the term "processing" in the registration requirement in a manner consistent with the SEF/SBSEF definition itself. Under this view, SEF/SBSEF registration would be required only for those who operate a system or platform for trading or executing swaps, including the essential processing inherent in the trading and execution functions.

Resolving the Apparent SEF/SBSEF Contradiction

Often courts and agencies will look to resolve an ambiguity in one part of a statute by reference to other provisions of the statute.[5] In this case, the goal of SEF/SBSEF registration, the

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[3] This difference is also manifest in financial services more generally—the "front office" trades and executes transactions and the "back office" reconciles, records and otherwise processes the actions of the front office. We believe in the definition of SEF/SBSEF Congress intended to cover the "front office" and essential related activities on trading platforms, but did not intend that "back office" activities alone—where no execution or price discovery occurs—would be covered by the new statutory definition and corresponding regulatory regime for SEFs/SBSEFs.

[4] *Robinson v. Shell Oil, Co.*, 70 F.3d 325, 328 (4th Cir. 1995) (en banc) (emphasis added); *see also Neff v. Capital Acquisitions & Management Co.*, 352 F.3d 1118, 1121 (7th Cir. 2003) (holding that regulatory requirement that "creditors" send monthly statements to debtors did not apply to defendant-entities where those entities did not meet the statutory definition of "creditor").

[5] *See, e.g., Dobrek v. Phelan*, 419 F.3d 259, 264 (3d Cir. 2005) ("In the event the [statutory] words and provisions are ambiguous . . . we look next at the surrounding words and provisions and also to the words in context.").

SEF/SBSEF core principles and the exchange-trading mandate support the proposed interpretation.

The Goal of SEF/SBSEF Registration and SEF/SBSEF Core Principles

Congress was very specific about the "goal" of the SEF registration requirement and applicable core principles in new CEA § 5h. In a provision entitled "Rule of Construction," Congress stated: "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." CEA § 5h(a)(1)(e).[6] Registering facilities that merely process swaps as SEFs will not promote either goal; pure processing facilities neither promote swaps trading, nor pre-trade price transparency. Facilities that post-execution process swaps and swap data would not satisfy the congressional goals for SEFs. In fact, Congress provided an entirely different registration category for swap data repositories that receive reports of executed swaps transactions.

Among the new SEF core principles, new CEA § 5h(f)(4) requires a SEF to "(A) establish and enforce rules or terms and conditions defining, or specifications detailing – (i) trading procedures to be used in entering and executing orders traded on or through the facilities of the [SEF]; and (ii) procedures for trade processing of swaps on or through the facilities of the [SEF]."[7] A SEF must have procedures both for entering and executing traded orders *and* for processing those trades in swaps. Similarly, in new CEA § 5h(f)(14)(C), SEFs are required to "periodically conduct tests to verify that the back up resources of the swap execution facility are sufficient to ensure continued . . . order processing *and* trade matching," among other functions.[8] Congress would not have required SEFs to have trading and execution procedures or to verify that back up resources are adequate for trade matching if SEFs were simply to be processing facilities for swaps already traded or executed elsewhere.

That several core principles require SEFs to establish rules solely with respect to the trading or execution of swaps further confirms that SEFs were not intended to be pure processing facilities. For example, new CEA § 5h(f)(2)(C) states that SEFs "shall . . . establish rules governing the operation of the facility, including rules specifying *trading procedures* to be used in entering and executing orders traded or posted on the facility, including block trades." (emphasis added).[9] New CEA §§ 5h(f)(7) ("Financial Integrity of Transactions") and 5h(f)(9)(B) ("Timely Publication of Trading Information") also require SEFs to take certain actions with

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[6] Congress did not include a similar Rule of Construction in the otherwise parallel SBSEF provision of the Securities Exchange Act.

[7] The parallel SBSEF core principle is found in new SEA § 3D(d)(4).

[8] The parallel SBSEF core principle is found in new SEA § 3D(d)(13)(C).

[9] The parallel SBSEF core principle is found in new SEA § 3D(d)(2)(C).

respect to the transactions entered or executed on or through those facilities.[10] The existence of these mandates that refer solely to trading and execution – and the notable absence of any core principles that deal exclusively with processing – again demonstrates that Congress did not intend SEFs to be mere processing facilities.

The SEF/SBSEF Exchange-Trading Mandate

Two of Dodd-Frank's central reforms are the clearing and exchange-trading mandates for swaps in Section 723 and security-based swaps in Section 763. These are two separate, but linked, mandates. First, derivatives clearing organizations (DCOs) and the CFTC must agree on what swaps will be subject to the clearing mandate. New CEA §§2(h)(1)(A) and 2(h)(2). Then, designated contract markets (DCMs) and SEFs must decide what clearable swaps to "make available for trading" under new CEA §2(h)(8).[11] The statute is clear: if a swap would be accepted for clearing by a DCO it must be cleared, absent an exemption; and if a clearable swap is listed for trading on a DCM or SEF it must be "executed" on a DCM or SEF.[12] Nowhere does Congress indicate that a swap may be "processed" on a SEF and still comply with the so-called exchange-trading mandate in CEA §2(h)(8). Congress used the word "executed" in this all important provision because it understood that SEFs would be "execution facilities," not mere processing platforms.

Moreover, Congress did not intend that DCOs, which perform processing functions for swaps, would be required to be registered as SEFs.[13] Indeed, if Congress had intended that just by participating in the processing of swaps a facility would need to register as a SEF, Congress would not have needed to enact any exchange-trading mandate – all DCOs that clear and process swaps would have been required to be registered as SEFs, thereby collapsing Dodd-Frank's two part clearing and exchange trading mandates into one. Nothing in the text or history of Dodd-Frank suggests Congress intended this result.

The Delta Options Case

New CEA § 5(h)(a)(1) does provide that registration as a SEF is required for those providing a facility for "trading or processing swaps."[14] The use of "or" could be cited to

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[10] The parallel SBSEF core principles are found in new SEA §§ 3D(d)(6) and 3D(d)(8)(B), respectively.

[11] The parallel clearing mandate for security-based swaps is found in new SEA §§ 3C(a)(1) and 3C(b).

[12] The parallel exchange-trading mandate for security-based swaps is found in new SEA § 3C(h).

[13] When Congress intended that a DCO could register as another entity, it made itself clear in the Act. New CEA § 21(a)(1)(B), for example, provides that a DCO may register as a swap data repository (SDR). The lack of a parallel provision permitting DCOs to register as SEFs shows that Congress did not intend such dual registration.

[14] New SEA § 3D(a)(1) contains the parallel SBSEF registration requirement.

support congressional intent to have pure swap processing facilities register as SEFs. But as the Commissions well know, agencies and courts will not read "or" in the disjunctive when doing so will lead to a result that undercuts other significant statutory provisions or purposes.

The second "Delta Options" case from the U.S. Court of Appeals for the Seventh Circuit provides an apt example. Delta Options concerned whether an electronic trading system for options on Treasury securities was an "exchange" under the Securities Exchange Act of 1934 ("Exchange Act").[15] The Exchange Act defines an "exchange" as "any organization, association, or group of persons…which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities *or* for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood." The SEC reasoned that the system was not an exchange because it was not "generally understood" to be a stock exchange within the meaning of the statutory definition.[16]

Competing, regulated futures exchanges challenged the SEC's action, arguing that the SEC improperly interpreted the Exchange Act because a system that brought together buyers or sellers of securities, without more, was an exchange under the literal terms of the statute. The court, however, agreed with the SEC, because the consequence of reading the "or" in the disjunctive (tantamount to inserting a comma before the word "or" the court observed) would have been inconsistent with the Exchange Act's structure and purposes.[17] In fact, the court reasoned that "even when [the statute is read] literally, which is to say without repunctuation of the statute and without overlooking the impossibility of a consistently literal reading," it did not support overturning the SEC's view. Applying a literal reading to the statute would have compelled the system to register as an exchange, something its structure precluded. This meant that "the system would be *kaput*."[18] The Court therefore affirmed the SEC's determination.[19]

Conclusion

Like the statutory provisions at issue in Delta Options, the SEF and SBSEF registration requirements in Dodd-Frank offer an interpretive challenge that makes a perfectly consistent literal reading of the new law impossible. But the harmonized approach we have offered is faithful to Dodd-Frank's key statutory provisions from the exchange-trading mandate to the core principles for SEFs/SBSEFs while also serving well the specific goals of the provision as identified by Congress. In contrast, imposing SEF and SBSEF registration on those simply

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[15] *See Board of Trade of the City of Chicago v. SEC*, 923 F.2d 1270 (7th Cir. 1991).

[16] *See id.* at 1272 (citing Exchange Act § 3(a)(1)) (emphasis added).

[17] *See id.*

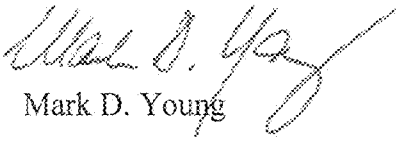
[18] *See id.* (emphasis in original).

[19] *See id.* at 1273.

operating facilities for processing swap transactions will thwart the goals of Congress and distort key statutory provisions. We respectfully urge the Commissions not to adopt that approach.

We thank the Commissions for their time and efforts in welcoming public comments on issues related to SEFs and SBSEFs and considering this letter's statutory analysis of Dodd-Frank's registration requirement for SEFs/SBSEFs. If the Commissions have any questions or would like further information, please do not hesitate to contact us.

Respectfully submitted,



Mark D. Young