Trading Facility – an Evolving Concept for US and Global Regulators and Implications for DeFi

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Today's presentation was prepared by ReedSmith

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Introduction

Peter Y. Malyshev

The New Regulatory Focus

- U.S. Securities and Exchange Commission (SEC) and the U.S. Commodity Futures Trading Commission (CFTC) have recently engaged in a coordinated effort to re-conceptualize what constitutes:
  - A regulated ***trading facility*** and
  - A regulated ***participant*** in the market
- These efforts are prompted by the rapidly changing market infrastructure and the advent of the blockchain technology, emergence of new digital assets, the drive toward retailification of commodity and derivatives markets and the proliferation of decentralized finance (DeFi).
- Both the SEC and the CFTC seek additional regulatory tools to police the digital assets markets and prevent fraud and manipulation.
- The European Securities and Markets Authority (ESMA) and regulators in Asia are engaged in similar efforts.

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Today's Discussion

- First, we discuss **CFTC's implementation** of the Dodd Frank Act of 2010 and former CFTC Chairman Gary Gensler's vision for market regulation and the implications of these reforms today for digital assets;
- Second, we discuss more recent **developments at the SEC**, also under Chairman Gary Gensler, that in many ways follow CFTC's blueprint;
- Third, we discuss similar **developments in Singapore**;
- Fourth, highlight the guidance from the international Financial Action Task Force (**FATF**) on virtual digital assets and the DeFi platforms; and
- Finally, we discuss proposed interpretation of regulated **trading**

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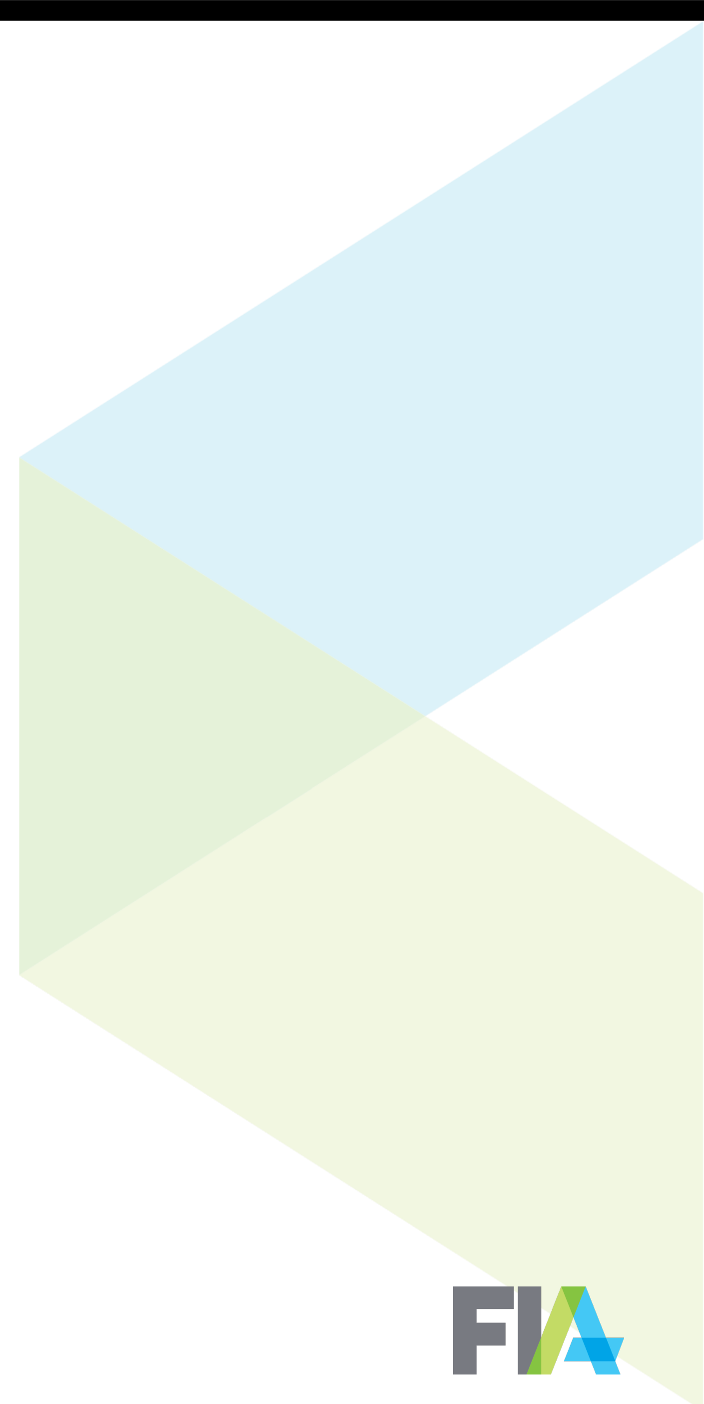
CFTC SEF Advisory

Jonathan Marcus



Overview of SEF Proposal and Interpretation

- The Dodd Frank Act of 2010 (124 STAT. 1376, P.L. 111–203, July 21, 2010) added the definition of the swap execution facility (SEF) to the Commodity Exchange Act of 1936 (CEA) (7 U.S.C. § 1 et seq.).
- In 2013 the CFTC implemented its final SEF rule that further defined SEFs (17 CFR Part 37).
- In 2018 the CFTC proposed but subsequently withdrew its proposed amendments to: (i) significantly expand the scope of a SEF; (ii) as well as qualify other market participants (such as IBs) as SEFs (83 FR 61946, Nov. 30, 2018).
- In September 2021 the CFTC's Division of Market Oversight (DMO) issued an advisory that essentially codified the 2018 withdrawn proposed SEF rule by asserting that the CFTC had applied its 2018 interpretation all along since 2013 (https://www.cftc.gov/PressRoom/PressReleases/8436-21).

SEF Definition

- The 2013 SEF rule (codified as Part 37 of CFTC regulations, 17 CFR) requires an entity to register as a SEF if it qualifies 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.

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CFTC Staff Advisory "Clarifies" Activities Potentially Triggering SEF Registration Requirement

- **September 29, 2021**: CFTC's DMO issued a Staff Advisory "clarifying" that "certain trading activities may trigger compliance with the SEF registration requirement in the [CEA] and CFTC regulations."
- Issued the same day the CFTC filed (and concurrently settled) charges against an entity that offered trading-related electronic communication services for failing to register as a SEF.

  - Defendant's platform described as "a technological tool for automated [RFQ] workflow for interest rate and cross currency swaps," which enabled "multiple swap market participants to select swap product parameters, such as swap type, clearing preference, tenor, and notional size to populate RFQs."

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When an Entity Might Need to Register as a SEF According to Staff Advisory

Entities that are:

(1) facilitating trading or execution of swaps through one-to-many or bilateral communications;
(2) facilitating trading or execution of swaps not subject to the trade execution requirement in CEA § 2(h)(8);
(3) providing non-electronic means for the execution of swaps; or
(4) currently registered with the CFTC in some other capacity, such as a commodity trading advisor or an introducing broker, if its activities fall within the SEF definition.

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Summary Interpretation of SEF Rules

- Existing Version (2013)
- Advisory Version (2021)

Existing Version (2013)	Advisory Version (2021)
"multiple participants "	*"bilateral, or one-to-one, or one to many communications"*
"have the ability"	*"chat function"* — Deemed to facilitate the execution of swaps
"through any means of interstate commerce"	*"facilities offering non-electronic methods of trading"*
"trading facility or platform"	*"registered entities"*

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Addressing the Activities of IBs

- The Staff Advisory’s fourth “clarification” specifically notes that SEF registration might be required of entities such as commodity trading advisors (CTAs) and introducing brokers (IBs).
- Not the first time CFTC has suggested that IBs might be acting as unregistered SEFs.
  - In 2018, the CFTC proposed but never finalized a rule that would have similarly interpreted the SEF registration requirement – and thus, in practice, what constitutes a SEF. This proposed rule also focused, in part, on the activities of IBs.

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Addressing the Activities of IBs

2018 (unenacted) rule proposal:

"Given that these interdealer brokers [registered as IBs] operate trading systems or platforms outside of the SEF regulatory framework that are very similar to the activity that occurs on trading systems or platforms that are located within interdealer brokers' registered affiliated SEFs, the Commission believes such activity would be more appropriately subject to a SEF-specific regulatory framework."

"[T]he Commission proposes that swaps broking entities, including interdealer brokers, that offer a trading system or platform in which more than one market participant has the ability to *trade* any swap with more than one other market participant on the system or platform, shall register as a SEF or seek an exemption from registration pursuant to CEA section 5h(g)."

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- The first of the clarifications in the SEF advisory as to what activities could trigger SEF registration --- “facilitating trading or execution of swaps through one-to-many or bi-lateral communications” --- is cause for concern not only for IBs but also for the burgeoning DeFi industry.
- Looser conception of the “multiple-to-multiple” requirement could snag DeFi protocols that facilitate one-to-many communications.

Potential APA Issues with Staff Advisory

- Staff Advisory is controversial from an Administrative Procedure Act (APA) perspective, given that the Staff Advisory addresses some of the same issues the unenacted 2018 proposed rule sought to address, without notice-and-comment rulemaking.
- In addition to procedural issues, there is the substantive question whether the staff interpretation is a reasonable interpretation of the statutory SEF definition.

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Potential APA Issues with Staff Advisory, cont'd

- **2013 SEF rule**: "The Commission continues to believe that a one-to-many system or platform on which the sponsoring entity is the counterparty to all swap contracts executed through the system or platform would not meet the SEF definition in section 1a(50) of the Act and, therefore, would not be required to register as a SEF under section 5h(a)(1) of the Act."
- **2021 DMO Staff Advisory**: "[A] facility may satisfy the multiple-to-multiple prong even if (i) the facility permits only bilateral, or "one-to-one," communications, and (ii) multiple participants cannot simultaneously request, make or accept bids and offers from multiple participants. Similarly, a facility may satisfy the multiple-to-multiple prong if the facility permits only "one-to-many" communications from which multiple participants can initiate a one-to-many communication."

Potential Retroactive Application of Staff Advisory

- From DMO's perspective, the September 2021 Staff Advisory was a clarification of the CFTC's interpretation of the SEF definition in the original 2013 SEF rule.
- Given that perspective, the CFTC could take the position that the newly "clarified" interpretation of the rule has retroactive application.
- The CFTC's Division of Enforcement could bring enforcement actions against facilities that believed they were in compliance with the 2013 SEF registration rule but would now fall within the definition of a SEF as interpreted in the Staff Advisory.

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SEC Proposed Reg ATS

Peter Y. Malyshev

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Overview of SEC's ATS and BD Proposals

- On January 26, 2022 the SEC proposed a rule (Proposal ATS) to:
  1. Expand the definition of "exchange" in § 3(a)(1) of the Securities Exchange Act of 1934 (the Exchange Act) by amending § 3b-16 under the Exchange Act; and
  2. Re-propose previous amendments to expand Regulation Alternative Trading Systems (ATS) for government and other securities, required disclosures, filings and fair access.
- On March 28, 2022, the SEC also proposed rules to significantly expand the scope of the broker-dealer definition (Proposal B-D) and further extend its reach to electronic trading systems not already captured by Proposal ATS.

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- § 3(a)(1) of the Exchange Act defines an "exchange" as:
    - [A]ny organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a ***market 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, and includes the market place and the market facilities maintained by such exchange."
- Rule § 3b-16 further expanded the scope of "exchange" in 1998 in response to technological changes to cover entities that:
    - Bring together the ***orders*** for securities of ***multiple buyers and sellers***, and
    - ***Use established, non-discretionary methods*** (whether by providing a trading facility or by setting the rules) under which such ***orders*** interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade. [existing version of the rule]

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Critical Revisions to Rule § 3b-16

- Existing Version

- *"orders"*
  - "any firm indication of a willingness to buy or sell a security, as either principal or agent, including any bid or offer quotation, market order, limit order, or other priced order" § 3b-16(c)
- ***"multiple buyers and sellers"***
  - The multi-to-multi requirement not to capture single dealer platforms or bulletin boards
- *"trading facility or setting rules"*
- *"use"*
  - "established, non-discretionary methods" arguably excluding discretionary methods

- Proposed Version

- *"trading interest"*
  - "an order… or ***any non-firm indication*** of a willingness to buy or sell a security that identifies at least the security and either quantity, direction (buy or sell), or price."
- ***"~~multiple~~"***
  - Deleted to make sure that RFQ systems will be captured
- ***"… or communication protocols…"***
  - To capture RFQ systems, indication of interest (IOI) platforms, stream axes, conditional order systems, negotiation chat systems
- *"makes available"*
  - To capture communication protocol systems as well as 3rd party systems functioning as exchanges or providing a marketplace for execution or transactions

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Impact of Proposed Revisions to Rule § 3b-16

- The expanded definition of “exchange” will now capture: *RFQ platforms, IOI platforms, chat or communication protocol systems or messaging platforms.*
- The expanded definition also captures functions collectively performed by various 3rd party participants, such as, DeFi systems, or systems facilitating digital asset blockchain transactions
  - (so long as these transactions involve securities).
- All existing platforms need to be re-examined for compliance, including those relying on the “old” definition of “exchange”.
- If the rule becomes effective, many additional platforms will need to register as: (i) exchanges or (ii) broker-dealers and comply with Reg ATS.

Proposal B-D

- As a companion to Proposal ATS, the SEC also sought to expand the scope of broker-dealer designation by further defining the phrase "***as part of regular business***" for purposes of the statutory definition of "dealer" and "government securities dealer" under § 3(a)(5) and § 3(a)(44) of the Exchange Act.
- Entities that qualify as "dealer" must register as "broker-dealers" and become SRO members.
- The focus of the proposal is to capture entities whose trading activities has the ***effect*** of providing liquidity in the market, even though they may not intend to be broker-dealers.
- If enacted, the effect will be to capture entities that:
    - Day traders who routinely make roughly comparable purchases and sales of similar securities;
    - Traders who routinely express "trading interests" at or near best available prices on both sides of the market and that are communicated to other market participants; and
    - Traders who earn revenue primarily from capturing bid-ask spreads.

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Potential Challenge to Proposal ATS

- As discussed with respect to SEFs, there are some indications that market participants believe that Proposal ATS is a significant overreach by the regulator and that a 30 day comment period (expires on April 18, 2022) is woefully inadequate.

Singapore Regulations

Hagen Rooke

Singapore regulation of multilateral trading platforms

- Under the Securities and Futures Act 2001, an “organised market” is defined as:

  - *“a place at which, or a facility (whether electronic or otherwise) by means of which, offers or invitations to exchange, sell or purchase derivatives contracts, securities or units in collective investment schemes, are regularly made on a centralised basis, being offers or invitations that are intended or may reasonably be expected to result, whether directly or indirectly, in the acceptance or making, respectively, of offers to exchange, sell or purchase derivatives contracts, securities or units in collective investment schemes (whether through that place or facility or otherwise)”.*

- One-to-one trading facilities are excluded from the definition.

- Under the Payment Services Act 2019, a "digital payment token exchange" is a place, or a facility (whether electronic or otherwise), where:
  - *"offers or invitations to buy or sell any digital payment token in exchange for any money or any other digital payment token (whether of the same or a different type), are regularly made on a centralised basis;*
  - *those offers or invitations are intended, or may reasonably be expected, to result (whether directly or indirectly) in the acceptance of those offers or in the making of offers to buy or sell digital payment tokens in exchange for money or other digital payment tokens (whether of the same or a different type), as the case may be; and*
  - *the person making any such offer or invitation, and the person accepting that offer or making an offer in response to that invitation, are different persons".*
- One-to-one trading facilities are excluded from the definition.

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Proposed expansion of digital payment token services

- New service to become regulated later in 2022:
- “*any service of inducing or attempting to induce any person to enter into or to offer to enter into any agreement for or with a view to buying or selling any digital payment token in exchange for any money or any other digital payment token (whether of the same or a different type)*”
- The Monetary Authority of Singapore has explained that this licensing requirement will capture, for example, “*an entity which carries on a business of providing brokerage or exchange services, or software applications, which enable users to find counterparties, and actively match orders for buyers and sellers of the DPTs, without taking possession of the moneys or DPTs*”.

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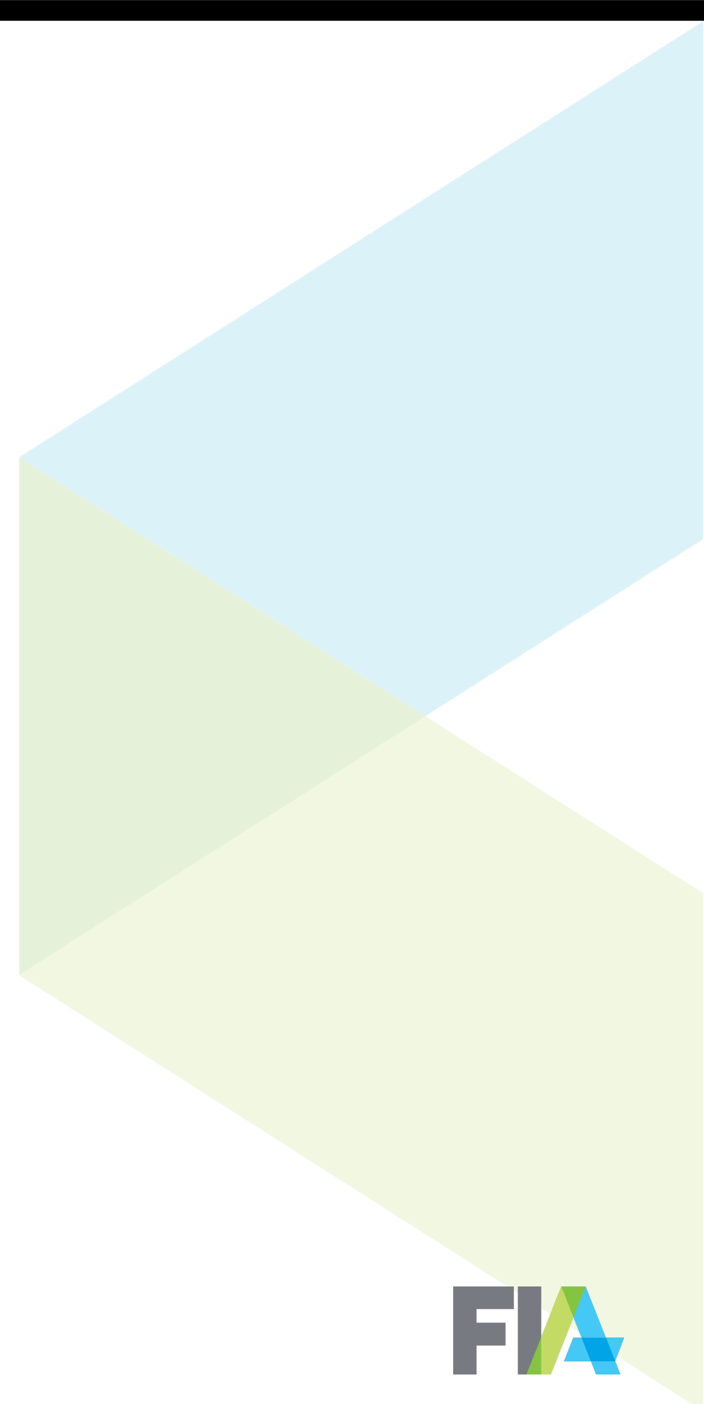
The FATF Guidance

Hagen Rooke



Background to the FATF guidance

- On 28 October 2021, the Financial Action Task Force (FATF), the global standard-setter for anti-money laundering and countering-the-financing-of-terrorism (AML/CFT) efforts, released its updated guidance for a risk-based approach on virtual assets (VAs) and virtual asset service providers (VASPs)
- The updated guidance is not legally binding on FATF member countries, but AML/CFT frameworks in these countries are now likely to converge with it over time.
- The updated guidance supersedes the first version published in June 2019.

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- The updated guidance focuses on six key areas:
- the definitions of VA and VASP;
- how the FATF standards apply to stablecoins;
- countering money-laundering and terrorist-financing risks for peer-to-peer transactions;
- licensing and registration of VASPs;
- implementation of the Travel Rule; and
- information-sharing and cooperation among VASP supervisors.

- Creators, owners, operators or other persons who:
  - maintain control or sufficient influence in DeFi platforms (e.g., decentralised applications (DApps) or decentralised exchanges (DEXs)); and
  - provide or actively facilitate VASP services
- may be considered VASPs, even if those arrangements seem decentralised or portions of the processes are automated.

Application to DeFi

- Non-exhaustive factors to be considered include:
- control or sufficient influence over assets or over aspects of the service’s protocol;
- an ongoing business relationship with users, even if this is exercised through a smart contract or voting protocols;
- profiting from the service; and
- having the ability to set or change the parameters of the service’s protocol (and a VASP is not released from AML/CFT obligations by virtue of having governance tokens).

- In relation to DeFi operators that are deemed VASPs, measures which FATF member countries can adopt include:
- requiring the VASP to facilitate transactions only to/from addresses or sources that are acceptable based on a risk assessment;
- requiring the VASP to facilitate transactions only to/from VASPs and other regulated entities (or else applying stricter AML/CFT measures);
- requiring the VASP to file reports on user transactions with unhosted wallets; and
- conducting enhanced regulatory scrutiny of VASPs that enable users to transact with unhosted wallets.

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ESMA Consultation Paper

Claude Brown

Consultation Paper On ESMA's Opinion on the trading venue perimeter

- Follows ESMA's final report on the functioning of Organised Trading Facilities (OTFs) under MiFID II.
- Clarifies the definition of multilateral systems (MTFs).
- Provides guidance on when systems should be considered MTFs.
- Considers scenarios that may give rise to de facto MTF operation by technology providers.
- Considers cases where pre-arranged transactions are ultimately executed on an authorized trading venue.
- Notes the legal requirement for MTFs to be properly regulated and subject to authorization as a trading venue or as a systematic internaliser.

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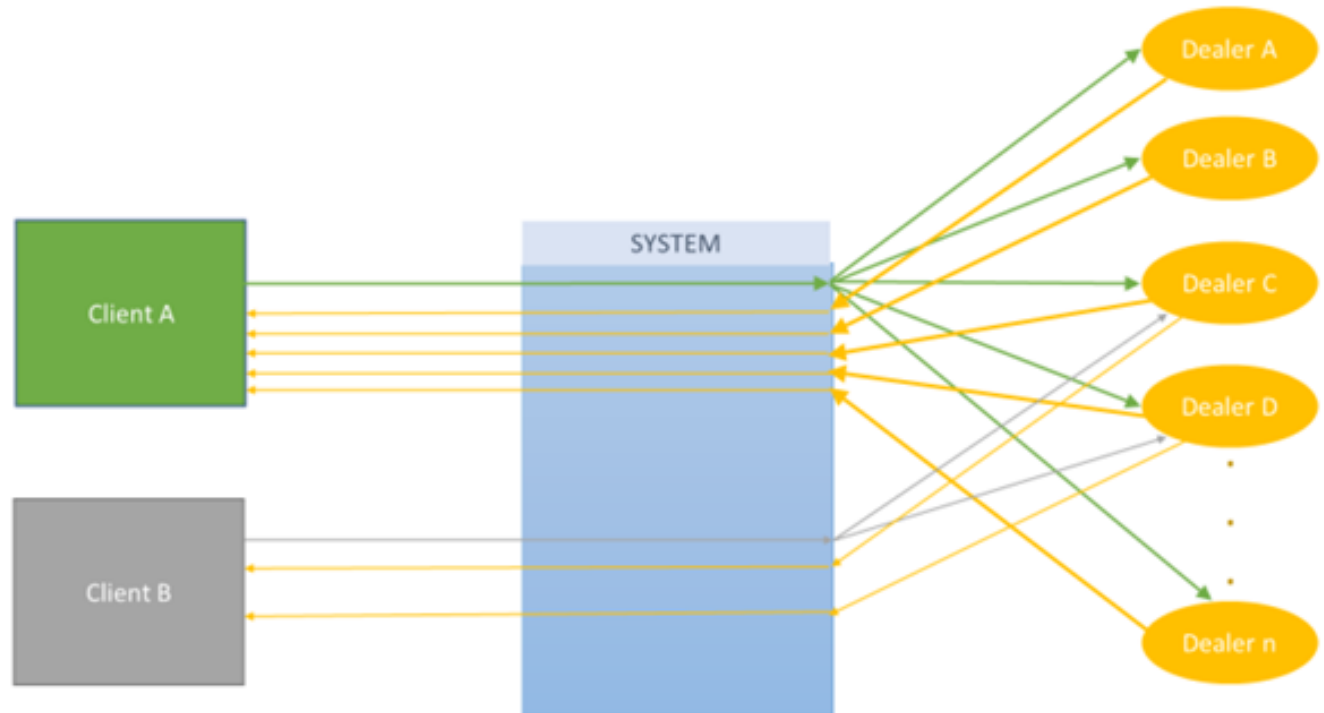
RFQ Systems

- Element of interaction between buying and selling interests.
- Possibility of interacting with multiple dealers through RFQ system.
- Regardless of the '1 to 1' nature of the transaction, ESMA considers this to be a multilateral system.



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ESMA Definition of Multilateral System

- ESMA's CP reminds entities that under MiFID II a multilateral system is one in which: there is a system or a facility, there are multiple third parties buying and selling interests, those trading interests need to be able to interact, and trading interests need to be in financial instruments.
- ESMA's definition of 'system' is a *"set of rules that governs how third-party trading interests interact"*. The type of technology used has no impact on whether it is considered to be a system and the mere existence of new technology such as an Application Programming Interface (API) does not mean a system falls outside the boundaries of MiFID II.
- "General-purpose communication systems", however, would fall outside the definition of 'multilateral systems'.
- Systems do not have to allow the conclusion of contracts to be considered MTFs. Allowing users to negotiate price, quantity etc. is sufficient to constitute an interaction of interests.

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