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**Potential Implications for Registrants and
Market Participants**

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This paper discusses the CFTC Division of Market Oversight (“DMO”) Advisory, published in September 2021, which addressed activities that may render an entity a swap execution facility (“SEF”)¹ and subsequent CFTC enforcement actions, including the September 2022 settlement between the CFTC and Asset Risk Management (“ARM”), a registered commodity trading advisor (“CTA”)² and potential issues arising therefrom. Further guidance is needed to clarify the contours of the SEF definition with an understanding of the basic activities of CTAs and commodity pool operators (“CPOs”). There may have been circumstances that supported a finding of SEF status with respect to ARM that are not obvious from the facts disclosed in the ARM order. Reading the order alone, however, it is not clear why old-fashioned, bog-standard CTA and CPO activity would not constitute acting as a SEF.

Background

Definition of Swap Execution Facility

The Commodity Exchange Act (“CEA”) defines a SEF as: (1) a trading system or platform (2) in which multiple participants have the ability to execute or trade swaps by accepting bids and offers (3) made by multiple participants in the facility or system, (4) through any means of interstate

¹ Staff Advisory on Swap Execution Facility Registration Requirement, CFTC Staff Letter No. 21-19 (the “Advisory”).

² *In the Matter of Asset Risk Management, LLC, CFTC Docket No. 22-36 (Sept. 26, 2022).*

commerce, including any trading facility, that — facilitates the execution of swaps between persons, and is not a designated contract market.³

Key to the SEF definition is the requirement that a SEF provide *multiple participants with the ability to execute or trade swaps by accepting bids and offers made by multiple participants in the facility or system* – sometimes referred to as the “multiple-to-multiple” prong of the SEF definition.

All entities that meet the definition of SEF in the CEA must register with the CFTC. Unlike other categories of CFTC registrants, no exemptions exist from the SEF registration requirement in CEA section 5h(a)(1) for a person that otherwise meets the definition.

The Advisory

In the Advisory, DMO further interprets the multiple-to-multiple requirement in a manner that many in the industry view as overbroad. For example, the Advisory states that one-to-many and bilateral communications can satisfy the multiple-to-multiple prong. DMO also states that if more than one participant can submit a request for quote (“RFQ”) to multiple participants on an entity’s system or platform, that may satisfy the multiple-to-multiple prong of the SEF definition. Moreover, the Advisory states that multiple participants do not need to be able to simultaneously make or accept bids or offers. This indicates that what would have once been viewed as a one-to-many communication between a single client and multiple potential counterparties is transformed into a multiple-to-multiple arrangement because the CTA or IB has multiple clients. Therefore, even though the CTA engages only in bilateral negotiations between one client and multiple prospective counterparties as agent on behalf of that one client, the fact that the CTA has more than one client satisfies the multiple-to-multiple prong, depending upon the facts and circumstances of the activity. This appears to be what occurred with ARM (discussed below). The Advisory does not address why an employee of a counterparty contacting a dealer directly is any different from a CTA acting as an agent of the counterparty contacting the dealer.

The Symphony Settlement

On the same day the Advisory was issued, the CFTC settled an enforcement action with Symphony Communication Services, LLC (“Symphony”) for

³ CEA Section 1a(50).

failing to register as a SEF.⁴ Symphony was not registered in any capacity with the Commission.⁵ The CFTC found that Symphony operated a communications platform, the “SPARC Tool,” that permitted multiple swap market participants to prepare and send RFQ messages to multiple other swap market participants. Recipients of the RFQ were then able to negotiate prices that could be confirmed via the SPARC Tool. The CFTC found that Symphony had operated a multiple-to-multiple platform designed to facilitate the trading of swaps, and thus should have been registered as a SEF or a designated contract market.

The ARM Settlement

ARM, a registered CTA, provided commodity trading advice to oil and natural gas producers. According to the settlement order, ARM recommended to its clients swap transactions that were intended to mitigate energy market price risks. Clients could ask ARM to obtain pricing for a particular type of commodity swap and ARM would then check with counterparties with whom the client had an ISDA agreement in place to determine potential pricing. Sometimes the client requested pricing from only one potential counterparty; other times, ARM would approach multiple counterparties for pricing. If the client gave ARM discretion to execute swap transactions on its behalf, then ARM would approve or reject any proposed pricing based upon the client’s parameters. Sometimes this execution would occur over chat or email between ARM and the counterparty. ARM would then confirm the terms of the swap transaction with the client. If ARM did not have discretion, ARM would typically join the client on a call with the counterparty during which the client would agree to the terms of the deal. The ARM order states that the CFTC found that “ARM operated a multiple-to-multiple trading system or platform designed to facilitate the execution of swaps,” and thus should have been registered as a SEF.⁶

Potential Implications

Standard Operations of CTAs and CPOs

It is difficult to know with certainty whether traditional CTA or CPO activities would trigger a SEF registration requirement, but the 2021 Advisory and

⁴ *In the Matter of Symphony Communication Services, LLC*, CFTC Docket No. 21-35 (Sept. 29, 2021).

⁵ As the Advisory states, registration with the Commission in one capacity does not mean that a party is not required to register in another category.

⁶ ARM at 4.

ARM suggest that they might. CTAs generally have multiple clients and CPOs often have multiple pools. Clients and pools often have ISDAs with multiple counterparties. Which counterparty to use for any given transaction may depend on the strength of the counterparty in a given market, its relative creditworthiness and other factors.

The ARM order creates an apparent anomaly. Clients of a CTA expect the CTA to obtain the best price available for a contemplated position. The only way a CTA can determine whether one dealer may offer a better price than another dealer is to ask both dealers. Seeking the best available price for transactions on behalf of its clients exemplifies the CTA exercising its fiduciary duty. Yet the ARM order suggests that a CTA is a SEF if the CTA (i) manages multiple clients pursuant to a given strategy (which is commonplace), (ii) determines to establish a position for those clients, (iii) requests quotes from multiple counterparties, and (iv) causes each such client to execute a transaction with the client's relevant counterparty (*i.e.*, potentially more than one counterparty). A CTA, when advising on the value or advisability of trading in commodity interests, is not generally thought of as operating a trading facility or platform. In the context of a CTA, moreover, the term "system" usually refers to the CTA's trading or investment strategy.

The same could be true for a CPO that operates and advises multiple commodity pools. The strategy for various of the CPO's pools may at times call for a similar position to be established. Thus, the CPO may reach out to multiple counterparties for pricing and execute transactions for each pool, perhaps with more than one counterparty. Is that multiple-to-multiple activity?⁷ In seeking to establish a position for one pool, a CPO may request quotes from multiple dealers. Is that a one-to-many communication that implicates the SEF definition as appears to be contemplated in ARM and Symphony?⁸

Open Questions

Certain fact patterns and definitions are not directly addressed in either the Advisory or the ARM settlement. The Advisory does not appear to contemplate that a CTA is acting as an agent for its client. Legally, this is no different than an employee of the client reaching out to multiple

⁷ See ARM at 3; Symphony at 3.

⁸ See ARM at 3-4 and Symphony at 3.

counterparties to execute a swap.⁹ In this case, instead of employing internal advisory personnel, the client has chosen to utilize the services of a professional advisor as its agent to negotiate the swap. Similarly, a CPO acts as agent for its pools. And notably, a pool generally does not have employees; it is a passive investment vehicle. Importantly, neither the Advisory nor the ARM settlement directly addresses what it means to be a “trading system or platform,” which is also an essential component of the SEF definition. Instead, both focus on what it means to have the “ability to execute or trade swaps” with multiple participants. The term “system,” like platform, is also not defined.¹⁰

As the Advisory correctly observes, registration in one category does not absolve a party from its obligation to register in another category, if its activities fall within the definition of such other category, absent a statutory or rule-based exclusion or exemption. Registration as a SEF would involve a fundamental change to a traditional advisory firm’s business model. A SEF has substantial obligations, among others, the supervisory responsibilities of a self-regulatory organization, order book functionality, and audit trail requirements. Moreover, even assuming a CTA registers as a SEF, in the case of a commodity asset class where swap transactions are highly customized and priced according to the creditworthiness of the relevant parties because they are uncleared, it may be difficult to actually operate an order book.

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⁹ CEA section 2(a)(1)(B) provides that “[t]he act, omission, or failure of any . . . agent . . . acting for any individual, association, partnership, corporation, or trust within the scope of his employment or office shall be deemed the act, omission, or failure of such individual, association, partnership, corporation, or trust, as well as of such official, agent, or other person.” In other words, under the CEA, an agent and its principal are treated as the same person.

¹⁰ The term “trading facility” is defined under CEA section 1a(51) and provides that the term does not include a “person or group of persons solely because the person or group of persons constitutes, maintains, or provides an electronic facility or system that enables participants to negotiate the terms of and enter into bilateral transactions as a result of communications exchanged by the parties and not from interaction of multiple bids and multiple offers within a predetermined, nondiscretionary automated trade matching and execution algorithm....”