CADWALADER

Cadwalader, Wickersham & Taft LLP
www.cadwalader.com

Clients&FriendsMemo

Expanding Regulatory Reach over Intermediaries That May Constitute Regulated Exchanges[1]

March 2, 2023

In response to changes in business practices, regulations and laws eventually change, too. During the past few years derivatives markets are witnessing this change as it applies to trading facilities as well as to entities that provide services that may be ancillary to intermediated swap execution. Indeed, the lines are becoming blurred between a traditional derivatives exchange and a facility or an entity that only a few years ago no one would recognize as an organized exchange.

U.S. financial regulators, such as the Commodity Futures Trading Commission ("***CFTC***") and the Securities and Exchange Commission ("***SEC***") struggle with conceptualizing whether, how and to what extent they can regulate intermediaries and the decentralized finance ("***DeFi***") facilities that offer swap execution services. On the one hand, an increasing number of intermediaries such as commodity trading advisors ("***CTAs***"), introducing brokers ("***IBs***"), swap dealers ("***SDs***") or unregistered and unregulated entities offer services that may facilitate execution of swaps on a multiple-to-multiple participant basis. On the other hand, decentralized autonomous organizations ("***DAOs***") that consist only of computer code and are controlled by tokenholders, that are not incorporated because incorporation is not available in most jurisdictions, or various other unincorporated technology providers, both can offer negotiation or execution services that are very similar to those of registered designated contracts markets ("***DCMs***") and swap execution facilities ("***SEFs***").

The CFTC and the SEC, together with the E.U.'s European Securities and Markets Authority ("***ESMA***") and the UK Financial Conduct Authority ("***FCA***"), collectively recognize that post-Dodd-Frank regulations need to be updated, but struggle with either reaching too far beyond the scope of a traditional exchange, or not reaching far enough to regulate a service, in whatever form it comes: execution of swaps on a multiple-to-multiple participant basis. This paper explores regulators' recent efforts at capturing these markets by regulation or enforcement, and also provides some

[1] The previous version of this paper was first published by the FIA Law & Compliance Division in connection with the FIA webinar on February 23, 2023.

takeaways from these developments as well as speculates on the likely impact on the markets in the U.S.

1. CFTC Enforcement and the Staff Advisory

a. *SEF Definition and the 2013 CFTC SEF Rule*

In response to the financial crisis of 2008, Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "***Dodd-Frank Act***" or "***Dodd-Frank***")[2] substantially amended the Commodity Exchange Act of 1936 ("***CEA***")[3] to abolish several forms of commodity derivatives and "swap"[4] trading, negotiation and execution facilities[5] and, in addition to the already existing DCMs, create a single form of a swap execution facility – as a SEF. The CEA defines a SEF as:

> The term "swap execution facility" 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 participants; and (B) is not a designated contract market.[6]

At first glance, this definition appears to provide sufficient certainty as to what a SEF is; however, upon further reflection many ambiguities become evident. First, from the definitional perspective, there are many terms that are simply not defined but nevertheless are critical to the construction of the concept of a SEF – what is a "trading system," or a "platform" or a "facility" or a "system"? Second, is the inclusion of the term "trading facility"[7] only an example in a list of other possibilities, or is it a qualifier for the entire definition? In other words, must a SEF necessarily be a "trading facility," or is the scope of SEF broader and only includes (but need not necessarily be) an entity

---

[2] Public Law 111-203, H.R. 4173 *et seq*.

[3] 7 U.S.C., 1a *et seq*.

[4] A "swap" is defined in Sec. 1a(47) of the CEA generally to only include non-security swaps.

[5] Before the Dodd-Frank amendments in 2010, there existed exempt commercial markets (ECMs), derivatives transaction execution facilities (DTEFs), exempt boards of trade, excluded electronic trading facilities, and a few others in addition to the DCMs. Each of these trading venues afforded great flexibility for market participants who could choose the most suitable form for their business association – ranging from a virtually unregulated and unregistered entity to a fully regulated DCM. After Dodd-Frank, DCMs remained largely unchanged, while all the other forms of trading facilities were rolled into the category of SEF.

[6] § 1a(50) of the CEA.

[7] § 1a(51). This definition of "trading facility" is critical to the understanding the scope of a SEF because it also provides an exclusion in (B) of the definition that carves out of the scope communication facilities where bilateral swaps are negotiated between participants but are not executed, or where bids and offers are not binding.

that would qualify as a "trading facility"? Third, will an entity that only "facilitates" the execution of swaps and that provides the "ability" without the actual execution of swaps – qualify as a SEF? Fourth, it is clear what a SEF is not – it is not a DCM, but given that a DCM is defined as a "board of trade" or "other trading facility,"[8] how can a SEF both be a "trading facility" but not "other trading facility" at the same time? Fifth, since the definition only refers to "ability to execute" instead of simply saying "execute," does it mean that swap negotiation facilities or facilities where bids and offers are not binding are within the scope of a SEF, while they are expressly excluded from the definition of a "trading facility"? Sixth, is there a difference between the "execute" or "trade" of a swap? Can one "trade" a swap without execution or vice versa? Seventh, would "any means of interstate commerce" include the telephone, or "pit trading," or a DAO running on a distributed ledger technology ("***DLT***") platform? Or does the reference to "multiple participants" mean "members"[9] in such trading system, or do these "participants" need not be formal "members"? The list of questions can go on. . . .

The CFTC issued their rules to further define a SEF and to implement SEF registration and regulation requirements in 2013 (the "***2013 CFTC SEF Rule***").[10] The 2013 CFTC SEF Rule was codified in Part 37 of CFTC regulations[11] and established a two-step process for compliance:

First, an entity must meet the definition of a SEF (deliberately or inadvertently) (CEA § 5h(a)(1) and CFTC Part 37.3(a)(1)); second, it needs to make a compliance decision: if an entity intends to become a registered SEF, it must comply with a set of CFTC requirements to become eligible for SEF registration; or if an entity does not want to become a SEF, it must stop acting as a SEF (or face the CFTC's enforcement action). This process was well understood and over 20 entities registered with the CFTC as SEFs. Many other entities stopped operating as SEFs and chose not to register.[12]

Even though the CFTC had issued a number of no-action letters and advisories, the market had worked out common methodologies on how to comply with the SEF regulations, which were steadily increasing. There nevertheless remained some aspects of the rules that were either not

[8] § 1a(6) of the CEA.

[9] As defined in § 1.3 of CFTC Regulations.

[10] *See* CFTC, Core Principles and Other Requirements for Swap Execution Facilities, 78 FR 33476, June 4, 2013.

[11] *See* 17 C.F.R., Part 37.

[12] The now notorious Footnote 88 in the 2013 CFTC SEF Rule adopting release states that not only facilities that offer the trading in swaps that are intended to be cleared and must trade on a SEF (made available to trade, or – "***MAT***") must register, but any facility that meets the definition of a SEF, regardless of whether it does or does not offer swaps intended to be cleared and MAT, must register as a SEF.

practicable,[13] or simply were not fully thought through;[14] and it was clear that the CFTC would need to either continue issuing no-action letters or amend the rules.

b. Proposed 2018 SEF Rule

In 2018 under CFTC's then Chair Christopher Giancarlo's leadership, the CFTC had proposed extensive amendments to the 2013 CFTC SEF Rule (the "***2018 CFTC SEF Proposal***").[15] In fact, the amendments were so substantial that the CFTC had introduced these amendments in the form of a proposed rulemaking and opened a public comment period, as required under the Administrative Procedure Act ("***APA***").[16] Proposed changes included, among other things, a revision to the functional definition of a SEF as well as the introduction of the notion that numerous otherwise regulated entities, such as CTAs, IBs, SDs and others would qualify as SEFs under the new rules (if adopted) and would be required to register as SEFs. The CFTC received an overwhelmingly negative response to these proposals and in 2021 the 2018 CFTC SEF Proposal was officially withdrawn.[17]

c. *The 2021 CFTC SEF Advisory*

On September 29, 2021, the CFTC issued an order filing (and simultaneously settling) charges brought against a California entity that offered finance and trading-related electronic communication services for failing to register as a SEF. The CFTC described the defendant as providing "a technological tool for automated request for quote ("***RFQ***") workflow for interest rate and cross currency swaps," and enabling "multiple swap market participants to select swap product parameters, such as swap type, clearing preference, tenor, and notional size to populate RFQs."[18]

The CFTC's Division of Market Oversight ("***DMO***") seems to have anticipated that this order's adoption of a novel SEF definition would be viewed as a significant departure from the SEF definition established in the 2013 CFTC SEF Rule. As a result, DMO concurrently issued a Staff Advisory[19] ("***2021 CFTC SEF Advisory***") clarifying that "certain trading activities may trigger

---

[13] *E.g.*, footnote 195 clarifies that a SEF is required to collect swap trading relationship documentation executed between the parties.

[14] *E.g.*, regulation of packaged transactions, or post-trade name give-ups, or some SEF reporting requirements.

[15] *See* CFTC, Swap Execution Facilities and Trade Execution Requirement – Proposed rule, 83 FR 61946 (November 30, 2018).

[16] The Administrative Procedure Act, Pub. L. 79-404, 60 Stat. 27, June 11, 1946.

[17] *See* CFTC, Swap Execution Facilities and trade Execution Requirement – Proposed rule, partial withdrawal, 86 FR 9304, 9304 (February 12, 2021).

[18] *See* In the Matter of: Symphony Communication Services, LLC. CFTC Docket No. 21-35, September 29, 2021.

[19] Staff Advisory on Swap Execution Facility Registration Requirement, CFTC Letter No. 21-19 (September 29, 2021).

compliance with the SEF registration requirement in the Commodity Exchange Act (CEA) and CFTC regulations."[20]

The 2021 CFTC SEF Advisory is controversial from an APA perspective, given that in 2018, as noted above, the CFTC proposed but never finalized its 2018 CFTC SEF Proposal that would have expanded the scope of the SEF registration requirement (*i.e.*, was a material change in the regulation) – and thus, in practice, what constitutes a SEF. The 2021 CFTC SEF Advisory arguably accomplished the result that the CFTC sought through the 2018 proposed rulemaking by the simple expedience of staff action and without following the procedures required by the APA.[21]

The 2021 CFTC SEF Advisory indicates that entities "may need to register as a SEF" when:

> (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 section 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 facility falls within the SEF definition.[22]

Of particular note for a large number of regulated or unregulated entities, and specifically for those in the DeFi space, is DMO's admonition that "facilitating trading or execution of swaps through one-to-many or bi-lateral communications" falls within the category of activities that could require SEF registration. This "clarification" was likely intended to cast doubt on the notion that certain platforms, including DAOs, are not subject to SEF registration (or any other CFTC regulations) because their protocols do not allow multiple participants to "simultaneously request, make, or accept bids and offers from multiple participants" or because their platforms act as a single liquidity provider (*i.e.*, one-to-many) and thus do not satisfy the "multiple-to-multiple prong" of CEA § 1a(50).[23]

On the latter point, the CFTC Staff Advisory specifically asserts that "a facility meets the multiple-to-multiple prong if multiple participants simply have the 'ability to execute or trade swaps' with multiple participants." The emphasis on "ability" drastically broadens the scope of the SEF definition. In fact, the 2013 CFTC SEF Rule specifically states that: "The Commission continues to believe that a one-to-many system or platform on which the sponsoring entity is the counterparty to

---

[20] *Id.*

[21] For example, the APA requires that the agency conduct the cost benefit analysis, provide notice to the public, provide an opportunity for public comment, and not effect the retroactive application of the rule, etc.

[22] *Id.*

[23] CEA SEF definition.

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." Clearly, there is a material disconnect between the 2013 CFTC SEF Rule and the 2021 CFTC SEF Advisory in that now, under the 2021 CFTC SEF advisory, even if an entity is a one-to-many platform (*i.e.*, not a many-to-many), so long as it provides merely the "ability" to execute swaps (*i.e.*, even if no swaps are actually executed on such platform), it will likely qualify as a SEF.

As stated in the 2021 CFTC SEF Advisory, and evidenced by the CFTC's concurrently announced charges and settlement in September 2021, the agency is looking closely at platforms offering "chat" functions that enable communications in a way that appears to give buyers and sellers the ability to execute derivative transactions (*i.e.*, swap trades). This broad interpretation could pull in any number of DAO platforms or other market participants, as well as more traditional financial services providers and potentially even other social and business digital communications platforms that offer capabilities related to or involving derivatives trading.

Importantly, because the CFTC Staff Advisory, from DMO's perspective, is merely a clarification of what the SEF definition has been since the 2013 CFTC SEF Rule, it will have retroactive application, meaning that the CFTC's Division of Enforcement could bring enforcement actions against facilities that believed they were in compliance with the 2013 CFTC SEF registration rule but would now fall within the functional definition of a SEF as outlined in the 2021 CFTC SEF Advisory.

d. *The 2022 Developments*

During 2022 the CFTC through enforcement as well as registration orders further pursued implementing its 2021 CFTC SEF Advisory in practice – essentially, engaging in regulation by enforcement.[24]

On January 3, 2022, the CFTC made clear that CFTC regulations applicable to SEFs and DCMs apply in equal measure to DeFi platforms by filing and settling charges against an event-based binary options exchange that was not registered as either a SEF or a DCM.[25] Given the number of unregistered platforms similarly offering derivatives in the market, many more actions of this nature are likely to ensue. CFTC Chair Rostin Behnam specifically noted in his Congressional testimonies of February 9, 2022, September 15, 2022 and December 1, 2022 that the CFTC will focus oversight on platforms where digital assets are traded.[26] CFTC's complaint filed with the

[24] *See* CFTC Press Release No. 8613-22, CFTC Releases Annual Enforcement Results (October 20, 2022).

[25] *See* In the Matter of Blockratize, Inc., d/b/a Polymarket.com, CFTC Docket No. 22-09 (January 3, 2022).

[26] Note that SEFs can give access to their trading platforms only to eligible contract participants ("***ECPs***"); while non-ECPs (*i.e.*, retail participants) can trade only on DCMs.

U.S. district court in the Northern District of California, CFTC v. Ooki DAO on September 22, 2022,[27] further illustrates Chair Behnam's point.

On July 20, 2022, the CFTC issued an order of SEF registration for AEGIS SEF, LLC,[28] immediately sparking the controversy. A number of market participants raised objections to the order as a further attempt to apply the 2021 CFTC SEF advisory in practice. Two CFTC Commissioners also raised concerns that the CFTC is overdue for an APA-compliant revision of the SEF rules, instead of a piecemeal approach of advisories, no-action letters, enforcement and registration orders.[29]

On September 26, 2022, in its ARM enforcement action,[30] the CFTC further illustrated in practice its understanding of what entities would qualify as SEFs by requiring that a registered CTA also register as a SEF. This enforcement action falls squarely within the parameters proposed in the 2018 CFTC Proposed SEF Rule. Clearly, however deficient the 2021 CFTC SEF Advisory may have been, the CFTC has all but elevated this advisory to the status of a Federal rule through its enforcement actions and orders of registration.

e. Implications for Market Participants

The combined effect of the 2021 CFTC SEF Advisory and registration and enforcement orders establishes a body of law that is likely to have a number of unintended (or maybe intended) consequences.

First, unless a clear regulatory action is taken in compliance with the APA, legal uncertainty around how market participants should execute their swap transactions will persist. Market participants may be forced to execute swaps that are not subject to the trade execution requirement on a SEF, which would be in competition to using the traditional services of an IB or CTA. Second, market participants will incur unnecessary costs to trade on a SEF with no potential of offsetting benefits. Third, the change in the SEF's scope could harm execution quality if trading counterparties do not

---

[27] *See* CFTC v. Ooki DAO (formerly d/b/a bZx DAO), an incorporated association, Case 3:22-cv-5416, September 22, 2022. *See also* In the Matter of bZeroX, L.L.C.; Tom Bean; and Kyle Kistner, CFTC Docket No. 22-31 (September 22, 2022).

[28] The CFTC had stated in the press release: "The CFTC issued the order under Section 5h of the Commodity Exchange Act (CEA) and CFTC Regulation 37.3(b). After review of AEGIS SEF's application and associated exhibits, the CFTC determined AEGIS SEF demonstrated its ability to comply with the CEA provisions and CFTC regulations applicable to SEFs." *See also* CFTC Grants AEGIS SEF, LLC, Registration as a Swap Execution Facility, July 20, 2022, CFTC Release 8560-22.

[29] "It has been over 10 years since the Dodd-Frank Act was passed. We must finally take action to fix unworkable rules by codifying "perpetual" no-action relief through notice-and-comment rulemaking as required by the Administrative Procedure Act. We must be as demanding on ourselves as we are on our registered entities and registrants—we must put in the hard work to comply with the letter of the law." Commissioner Caroline Pham. Both Commissioners Pham and Summer Mersinger demanded that the CFTC follow proper rulemaking procedures instead of the ad hoc letters or advisories.

[30] *See* In the Matter of Asset Risk Management, LLC, CFTC Docket No. 22-36 (September 26, 2022).

participate on the SEF or choose not to use "any means of interstate commerce" that may even remotely resemble a SEF functionality. Finally, this change could cause the loss of valuable execution support provided by CTAs and IBs, when market participants may not have the resources or operational set-up to contact their trading counterparties to negotiate and execute swap transactions on a strictly one-to-one and bilateral basis.

Entities that would otherwise act as traditional CTAs or IBs would shy away from providing these services in fear of inadvertently qualifying as SEFs, while there is a fundamental difference between a "registrant," such as CTA or an IB, and a "registered entity," such as a SEF. "Registrants" typically serve as fiduciaries to their customers, while "registered entities" act as self-regulatory organizations ("***SROs***") that do not owe any fiduciary duties to their members and participants.

Furthermore, there is a significant concern among market participants, such as SDs, that transacting with entities that are CTAs or IBs, or with counterparties that are represented by or trade through CTAs and IBs, may expose them to an aiding and abetting liability if these CTAs and IBs may have failed to also register as SEFs. In many instances SDs would not be able to obtain requisite representations and warranties from these CTAs and IBs that would state that they are not required to be registered as SEFs, and SDs are not required to act as their counterparties' lawyers or auditors. Given these risks, SD would simply shy away from transacting or dealing with any CTA or IB, which would further damage the CTA and IB industry.

2. SEC's Regulations

a. *The SEC's Proposed ATS Rule*

On January 26, 2022, the SEC released a proposal to amend Rule 3b-16 of the Securities Exchange Act of 1934 ("***Exchange Act***") with respect to alternative trading systems ("***ATSs***") ("***SEC ATS proposed rule***").[31] Although the focus of the SEC ATS proposed rule is on the definition of "exchange" under Section 3(a)(1) of the Exchange Act as it relates to U.S. government and Treasury securities, that focus should not obscure the proposal's additional aim of expanding the exchange concept "to include systems that offer the use of non-firm trading interest and communication protocols to bring together buyers and sellers of securities." In practice, this proposed amendment would broaden the scope of the definition of "exchange" to capture not only actual orders placed on securities exchanges, but also "non-firm trading interests," including conditional offers and exploratory solicitations for securities trades. The amendment would also

[31] Amendments Regarding the Definition of "Exchange" and Alternative Trading Systems (ATSs) That Trade U.S. Treasury and Agency Securities, National Market System (NMS) Stocks, and Other Securities, Proposed Rule, 87 FR 15496 (March 18, 2022).

provide the SEC with newly codified authority to oversee and regulate communication protocol systems ("***CPSs***").[32]

SEC Commissioner Caroline Crenshaw described the proposed expansion of SEC authority over platforms on which solely "non-firm trading interests" are exchanged as the long-needed removal of a "loophole" used to evade SEC rules. Specifically, to capture CPSs, the SEC proposes amending the term "exchange" to include any "organization, association, or group of persons" that is not otherwise subject to an exemption if it:

> (1) brings together buyers and sellers of securities using trading interest; and (2) makes available established, non-discretionary methods (whether by providing a trading facility or communication protocols, or by setting rules) under which buyers and sellers can interact and agree to the terms of a trade.

The SEC ATS proposed rule provides a non-exhaustive list of CPSs that would be subject to registration and oversight, including RFQ systems; so-called "stream axes," which electronically provide a continuous flow of firm and non-firm trading offers on a security to those on the platform, some conditional order systems; and negotiation systems that bring together buyers and sellers via a "bilateral negotiation protocol."

Although SEC Chair Gary Gensler described these amendments as necessary to adapt the agency's regulations to a world in which exchange platforms are "increasingly electronified," this action by the SEC is also a shot across the bow for DeFi platforms offering blockchain-based, algorithmically facilitated platforms on which securities trades are facilitated or communicated.

Some would argue that the DeFi platforms currently operating autonomous or semi-autonomous protocols that provide communications functions or other related services to potential buyers and sellers of securities are not covered by the Exchange Act's current definition of "exchange." These amendments would, at least in some instances, bring those platforms more clearly under the SEC's jurisdiction, first and foremost by requiring them to register with the agency as an exchange or as a broker-dealer or an ATS.

b. *SEC's SEF Rule*

On April 6, 2022, the SEC finally re-proposed its SEF rules for security-based swaps ("***2022 SEC SEF Proposal***").[33] The SEC's proposal states that: "the [SEC] preliminarily believes that it should

[32] Additionally, as noted above, as part of this amendment package, the SEC proposed to remove an exemption under Regulation ATS for alternative trading systems (ATSs) that facilitate trading of U.S. Treasury securities and other government securities, in order to bring them "under the regulatory umbrella."

[33] *See* Rules Relating to Security-Based Swap Execution and Registration and Regulation of Security-Based Swap Execution Facilities, SEC proposed rule, withdrawal of proposed rules, 87 FR 28872 (May 11, 2022).

harmonize as closely as possible with the CFTC on foundational terms such as 'trading facility,' 'electronic trading facility,' and 'order book' because the CFTC's reliance on these terms over several years has created understanding of what type of functionality a SEF must offer." This means that the body of law and CFTC's interpretations of what constitutes a SEF could largely transfer over to the SEC as well and participants in security-based swap markets will have to face the same issues discussed in this paper.

3. ESMA's Consultation Paper

Two days after the release of the SEC ATS proposed rule in January of 2022, the ESMA published a consultation paper ("***CP***") setting forth "ESMA's Opinion on the trading venue perimeter." ESMA's paper seeks to further "clarify . . . the definition of multilateral systems and provid[e] guidance on when systems should be considered as multilateral systems and, as consequence, seek for authorization as trading venues."

Very similarly to the 2021 CFTC SEF Advisory and SEC ATS proposed rule, ESMA's CP aimed to clarify when a trading venue becomes subject to the authorization requirement as either an organized trading facility ("***OTF***") or a multilateral trading facility ("***MTF***"). "In particular, the CP looks at [RFQ] systems and new technology providers that may, in some instances, operate de facto a multilateral system without proper authorization."

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 those trading interests need to be in financial instruments. The CP also looks at recent technology and market developments, including bilateral negotiation and communication protocols, as well as RFQ and order management and execution systems.

Following this consultation, on February 9, 2023, ESMA had published its final report containing the final opinion on ESMA's Opinion on the trading venue perimeter where it followed the outline in CP and finalized its interpretation to include communication protocols as one of the indicia of a trading venue ("***2023 ESMA Trading Venue Report***"). It considered in detail the following concepts: "definition of a multilateral system" (a system or facility), "multiple third-party buying and selling interests," "interaction between trading interests," scope of technology providers and communication tools, request-for-quote systems, systems that pre-arrange transactions. The 2023 ESMA Trading Venue Report is a product of a mutual regulatory and market participants' collaborative effort and is a thorough document that provides greater clarity than the 2021 CFTC SEF Advisory.

4. FCA Consultation Paper

In September 2022 as part of its Wholesale Markets Review conducted with HM Treasury, the UK's Financial Conduct Authority ("***FCA***") published Consultation Paper CP22/18 on new guidance on the regulatory perimeter for trading venues. The FCA paper examines the same concepts and constructs as the ESMA 2023 Trading Venue Report and proposes guidance to be included in the FCA Handbook's Perimeter Guidance Manual to clarify the definition of a multilateral system, as well as on specific arrangements in financial markets in the form of Q&As.

Like ESMA, the FCA is looking to adapt a regulatory framework to deal with ambiguities in the application of the MiFID definition of multilateral system when distinguishing between unregulated communication arrangements, firms that are authorized to arrange deals in investment and regulated trading venues (the MiFID II term that encompasses regulated markets, multilateral trading facilities and organized trading facilities). It proposes doing so by giving guidance on each of the four elements of the definition of a multilateral system, being:

1. Having the characteristics of a trading system or facility;

2. Comprising multiple third-party buying and selling trading interests;

3. Allowing trading interests to interact in the system; and

4. Those trading interests are in financial instruments (as defined in the Regulated Activities Order).

The guidance will also cover specific arrangements and how they work under the definition, including voice broking, portfolio managers operating internal matching systems, bulletin boards, investment-based crowdfunding firms operating primary market platforms and the systems operated to block trades onto trading venues.

The consultation closed on November 25, 2022 and a policy statement is expected in Q2 2023.

5. Proposed Regulations Applicable to Digital Assets

The first of the clarifications in the 2021 CFTC 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 also a cause for concern not only for IBs and CTAs, 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.[34] The Digital Commodities Consumer Protection Act ("***DCCPA***") introduced by Senators Stabenow and Boozman on August 3, 2022 already attempts to cover this functionality in the recent markup:

> "(24) DIGITAL COMMODITY TRADING FACILITY.— 27 "(A) IN GENERAL.—The term 'digital commodity trading facility' means a trading facility ~~that facilitates the execution or trading of~~ **on or through which** digital commodity trades ~~between persons~~. **are executed**. ~~"(B) Exclusion.—The~~"(B) EXCLUSIONS.—The term 'digital commodity trading facility' does not include a person solely because that person— "(i) validates digital commodity transactions; or "(ii) **develops or publishes software**.";[35]

As follows from the redline, the SEF-like language of "facilitates the execution or trading" is removed in favor of a more clear and direct – "are executed".

Conclusion

CTAs, IBs, DAOs and businesses collaborating with them, including companies providing digital communications services in the financial services sector or entities that trade with or through these entities,[36] should closely analyze the CFTC's, SEC's, and ESMA's recent actions. Even if these regulators did not formally coordinate their approach, the substance of the CFTC, the purpose of the SEC ATS proposed rule, as well as the scope of ESMA's consultation paper and FCA's approach, all indicate that the regulators are attempting to do the same thing: scope the outside boundaries of what constitutes a regulated trading facility.

These developments not only foreshadow increased regulatory scrutiny and compliance costs for the derivatives, commodity and digital asset industry but also send the signal that the CFTC, the SEC, the ESMA and other regulators, at times in either an actual or seemingly coordinated manner, will be looking for ways to extend and apply their authorities to the rapid technological changes that are fundamentally altering the structure of the financial markets.

The practical effects of the 2021 CFTC SEF Advisory are likely to be:

---

[34] In the January 3, 2022 enforcement order In re Polymarket, CFTC found that a DeFi blockchain operated prediction market was unregistered as a DCM or a SEF.

[35] The October 2022 unofficial markup.

[36] Trading with an unregistered entity may be considered adding and abetting in the perpetration of an illegal conduct. Also, NFA's Bylaw 1101 prohibits its members from transacting with entities that should have been registered, such as a market participant that may be found operating an unregistered SEF.

- any platform or facility (registered or unregistered) offering a chat function (even one-on-one) that provides an ability to execute swaps would be under enhanced CFTC's scrutiny;
- CTAs could be reluctant to transact in OTC markets and introduce customers to bilateral transactions;
- new SEFs may have to essentially operate as trade confirmation and reporting facilities;
- forcing CTAs to become SEFs could interfere with their roles as fiduciaries to customers;
- other entities, such as swap dealers, would be reluctant to use CTA services fearing potential aiding and abetting liability for transacting with a potentially unregistered SEF; and
- calling into question other intermediary models, such as riskless principals acting as SDs or entities acting as give-up brokers.

* * *

If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

Peter Y. Malyshev	+1 202 862 2474	peter.malyshev@cwt.com
Maurine Bartlett	+1 212 504 6218	maurine.bartlett@cwt.com
Ivan Loncar	+1 212 504 6339	ivan.loncar@cwt.com
Alix Prentice	+44 (0) 20 7170 8710	alix.prentice@cwt.com
Mercedes Tunstall	+1 202 862 2266	mercedes.tunstall@cwt.com