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SEC Launches Regulation for Security-Based Swap Execution Facilities

Regulation SE, the last of the Title VII Dodd-Frank rulemakings, will become effective on February 13, 2024.

The Securities and Exchange Commission (SEC) has taken a significant step in enhancing the regulatory landscape of the financial markets by adopting new Regulation SE (17 CFR 242.800 through 242.835) under the Securities Exchange Act of 1934 (Exchange Act).¹ The final rules establish a comprehensive framework for the registration and oversight of security-based swap execution facilities (SBSEFs) in compliance with Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). As the last of the rulemakings required under Title VII of Dodd-Frank, the much anticipated Regulation SE will become effective on February 13, 2024 (Effective Date).

Regulation SE aligns the SEC's regime closely with the Commodity Futures Trading Commission's (CFTC's) swap execution facility rules, emphasizing transparency, pre-trade pricing, and risk reduction in the security-based swap markets. Regulation SE addresses the Exchange Act's trade execution requirement for security-based swaps, cross-border application, conflicts of interest mitigation, and fosters consistency with existing Exchange Act rules.

SBSEF Registration and Key Rules

Registration

Currently, entities meeting the definition of SBSEF are able to rely on temporary exemptions issued by the SEC pursuant to Section 36(a)(1) of the Exchange Act that exempts them from the requirement to register as an SBSEF or national securities exchange.² The temporary exemptions will remain effective until the earliest compliance date for SBSEF registrants as set out in further detail below.³

Rule 803 of Regulation SE describes the requirements and procedures for SBSEF registration. Under Rule 803, any entity that meets the definition of SBSEF is required to register with the SEC as an SBSEF on Form SBSEF⁴ or register as a national securities exchange.⁵ Certain foreign trading venues may seek exemptions, pursuant to Rule 833(a), from the requirement to register. According to Rule 803, an SBSEF is defined as "a trading system or platform in which more than one market participant has the ability to execute or trade security-based swaps with more than one other market participant on the system or platform."⁶ The definition of SBSEF tracks the definition of swap execution facility under the CFTC Rules

closely.⁷ However, the SEC declined to adopt or acknowledge the application of the CFTC Advisory 21-19 (CFTC Advisory 21-19),⁸ which clarifies that the SEF definition includes “facilities offering one-to-many or bilateral communications if more than one participant is able to submit an RFQ on the platform.”⁹ Importantly though, while not acknowledging the expansive interpretation of CFTC Advisory 21-19, the SEC declined to reject the CFTC Advisory 21-19 interpretation. This decision indicates that depending on the facts and circumstances and examples which may arise after the rule becomes effective, the SEC may similarly find that certain bilateral (and not simultaneous) and one-to-many communication protocols fall within the scope of the definition of SBSEF. The SEC further clarifies that single-dealer “one-to-many” trading platforms that do not offer multiple-to-multiple trading are outside the scope of the SBSEF definition and do not require registration with the SEC under Regulation SE. This also aligns with the CFTC interpretation of excluding true single-dealer platforms.

Any entity that meets the definition of SBSEF must file an application with the SEC to register as an SBSEF on Form SBSEF at any time after the Effective Date. The temporary SBSEF exemptions discussed above expire 180 days after the Effective Date for any entity that has not filed an application to register with the SEC on Form SBSEF; thus, any entity that meets the definition of SBSEF and engages in the activities of SBSEFs, but which has not submitted an application on Form SBSEF by 180 days after the Effective Date, will be in violation of the registration requirements of Rule 803. For any entity that has submitted an application on Form SBSEF by 180 days after the Effective Date, the exemptive relief relating to SBSEF registration expires 240 days after the Effective Date, unless such entity’s application on Form SBSEF is complete (i.e., having responded to any SEC requests for revisions or amendments) within 240 days after the Effective Date. Such entities with complete applications will continue to benefit from the exemption until 30 days after the SEC approves or disapproves the application on Form SBSEF. An entity not meeting either compliance date would have to cease all operations as an SBSEF.

Core Principles

Regulation SE sets forth 14 core principles with which SBSEFs must comply (SBSEF Core Principles), closely paralleling the 15 core principles for SEFs under the Commodity Exchange Act, as amended (CEA).¹⁰ The SBSEF Core Principles are summarized below.

1. *Compliance with Core Principle.* Any entity that meets the definition of SBSEF is required to register and maintain registration as an SBSEF and to comply with the SBSEF Core Principles. SBSEFs shall have reasonable discretion in establishing the manner in which the SBSEF complies with the SBSEF Core Principles.
2. *Compliance with Rules.* SBSEFs must establish and enforce compliance with its rules, while also ensuring the capacity to detect, investigate, and enforce rules to prevent abuses and provide impartial market access.
3. *Security-Based Swaps (SBS) Not Readily Susceptible to Manipulation.* SBSEFs shall permit trading only in SBS that are not readily susceptible to manipulation.
4. *Monitoring of Trading and Trade Processing.* SBSEFs shall establish and enforce rules specifying trading and trade processing procedures for SBS, and monitor trading to prevent manipulation and disruptions.
5. *Ability to Obtain Information.* SBSEFs shall institute and enforce rules enabling the acquisition of essential information for the SBSEF to perform functions described in the core principles, and provide the information to the SEC on request.

6. *Financial Integrity of Transactions.* SBSEFs shall establish and enforce rules and procedures to ensure the financial integrity of SBS entered on, or through the facilities of, the SBSEF. In addition, SBSEFs shall also monitor their members to ensure that they continue to qualify as eligible contract participants.
7. *Emergency Authority.* SBSEFs shall establish rules enabling the exercise of emergency authority, including the authority to liquidate or transfer open positions and to suspend or curtail trading in any SBS.
8. *Timely Publication of Trading Information.* SBSEFs shall make public timely information on price, trading volume, and other trading data on swaps to the extent prescribed by the SEC.
9. *Recordkeeping and Reporting.* SBSEFs shall (a) maintain records of all business-related activities, including a complete audit trail, in a form and manner acceptable to the SEC for a five-year period, (b) provide the SEC with necessary or relevant information in a manner acceptable to the SEC, and (c) allow the SEC to inspect and examine any swap-related records.
10. *Antitrust Considerations.* SBSEFs are prohibited from establishing rules or actions that lead to any unreasonable restraint of trade or impose any material anticompetitive burden on trading or clearing.
11. *Conflicts Of Interest.* SBSEFs are required to institute and enforce rules to minimize conflicts of interest in their decision-making process; and establish a process for resolving the conflicts of interest.
12. *Financial Resources.* SBSEFs shall have adequate financial, operational, and managerial resources to discharge each responsibility of the SBSEF. Financial resources shall be considered adequate if (a) they can meet obligations during a default by the member or participant with the largest financial exposure in extreme market conditions, and (b) exceed the amount necessary to cover one year of operating costs.
13. *System Safeguards.* SBSEFs shall establish and maintain (a) a risk analysis program that aims to identify and minimize sources of operational risk, and (b) emergency procedures, backup facilities, and a plan for disaster recovery that allow for timely recovery and resumption of operations. SBSEFs are also required to conduct periodic tests to ensure backup resources are sufficient to ensure continued operations and fulfillment of the SBSEF's responsibilities.
14. *Designation of Chief Compliance Officer.* SBSEFs shall designate a chief compliance officer, who is responsible for overseeing compliance with the SBSEF Core Principles, addressing conflicts of interest, establishing necessary policies and procedures, devising remediation measures for noncompliance, and submitting an accurate and complete annual compliance report to the SEC.

Procedures for Rule and Product Filings

Regulation SE provides SBSEFs with two distinct avenues for rule and product listing and regulatory submissions. SBSEFs have the option to utilize a self-certification process when listing new products, affirming compliance without mandatory SEC review.¹¹ Alternatively, the SEC also allows SBSEFs to voluntarily submit new SBS products for SEC scrutiny and approval.¹² Similarly for rule listings, the regulatory landscape further includes procedures for SBSEFs to implement a rule or rule amendment via self-certification. Alternatively, SBSEFs can also voluntarily submit rules, rule amendments, or dormant rules for comprehensive SEC review, allowing for preemptive approval before implementation.¹³ The SEC will approve a new rule or rule amendment, unless doing so would be inconsistent with the Exchange Act or the SEC's rules thereunder.¹⁴

These regulations pertaining to product and rule filings closely resemble those of the CFTC. One significant distinction is that the SEC prolongs the initial self-certification review period, as stipulated by the CFTC, from one (1) business day to ten (10) business days.¹⁵ In accordance with the parallel provisions in § 40.2(a) of the CFTC's rules, the CFTC mandates that a DCM or SEF file the self-certification just one business day before the product listing. In contrast, the SEC specifies that the SEC must receive the submission by the close of business on the business day that precedes the product's listing by 10 business days. The SEC rationalizes this extension by asserting that a one-business-day period would not afford SEC staff with sufficient time to thoroughly assess a new product filing for errors or incompleteness, let alone scrutinize the product for compliance with the Exchange Act or Regulation SE. Additionally, if a product warrants a stay, the SEC would require adequate time to follow the administrative procedures for formally issuing the stay.¹⁶

Trade Execution Requirements: SBS Product Must Be MAT

The SEC is adopting a comparable approach to the CFTC rules concerning trade execution requirements. Specifically, an SBS product becomes subject to the trade execution requirement outlined in Regulation SE only if the product, obligated to mandatory clearing, is listed and a MAT (Made Available to Trade) determination has been issued.¹⁷ Essentially, for the trade execution requirement to be activated, an SBSEF must make a MAT determination under Rule 816, and submit the MAT determination to the SEC, following the procedures established by either Rule 806 (voluntary submission for SEC review and approval) or Rule 807 (self-certification), which mirrors the MAT process in § 37.10 of the CFTC's rules.¹⁸ Conversely, the SEC may issue a determination that an SBS is no longer MAT if it determines that no SBSEF or SBS exchange lists that SBS for trading.

In addition, proposed Rule 815(a)(2) stipulates that, except for block trades or the exceptions detailed in paragraphs (d) or (e) of the rule, the mandatory execution methods for a Required Transaction should be either: (a) an order book, or (b) an RFQ (Request for Quote) system used in conjunction with an order book, and the rule allows SBSEFs to utilize any means of interstate commerce to provide such execution methods.¹⁹

Cross-Border Considerations

Considering the widespread participation of counterparties in the global SBS market, the SEC introduced Rule 832 under Regulation SE to specify the circumstances under which the trade execution requirement applies to cross-border SBS transactions. According to Rule 832, the trade execution requirement only applies to an SBS if at least one counterparty to the SBS is considered a "covered person," as defined as either 1) a US person,²⁰ 2) a non-US person whose performance under an SBS is guaranteed by a US person, or 3) a non-US person who, in the course of its SBS dealing activity, utilizes US personnel situated in a US branch or office, or personnel of an agent of such non-US person located in a US branch or office, to arrange, negotiate, or execute a transaction.²¹

Furthermore, Rule 833(b) allows foreign trading venues that previously obtained exemptive relief from the CFTC for swaps trading to seek similar exemptions under Rule 833(b), provided that they already adhere to robust regulatory regimes comparable to those governing SBS transactions in the US.²²

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Endnotes

¹ SEC, Security-Based Swap Execution and Registration and Regulation of Security-Based Swap Execution Facilities, Exchange Act Release No. 34-98845 (Nov. 2, 2023), available [here](#). The SEC proposed Regulation SE on Apr. 6, 2022. See Rules Relating to Security-Based Swap Execution and Registration and Regulation of Security-Based Swap Execution Facilities (Proposed Rule), Exchange Act Release No. 34-94615 (Apr. 6, 2022), 87 FR 28872 (May 11, 2022) (Proposing Release).

² See Exchange Act Release No. 34-64678 (June 15, 2011), 76 FR 36287 (June 22, 2011) (providing a temporary exemption for entities that meet the definition of "security-based swap execution facility" from the requirement to register with the SEC as an SBSEF); Order Granting Temporary Exemptions under the Securities Exchange Act of 1934 in Connection with the Pending Revisions of the Definition of "Security" to Encompass Security-Based Swaps, Exchange Act Release No. 64795 (July 1, 2011), 76 FR 39927 (July 7, 2011) (providing a temporary exemption for entities that meet the definition of "security-based swap execution facility" from the restrictions and requirements of Sections 5 and 6 of the Exchange Act). An entity that meets the definition of "security-based swap execution facility" must register as an SBSEF under Section 3D of the Exchange Act or as an exchange under Section 6 of the Exchange Act. However, because the SEC has not previously adopted final rules relating to SBSEFs, such entities have not been able to so register as SBSEFs. The temporary SBSEF exemptions have allowed these

entities to continue trading SBS without needing to register either as SBSEFs or national securities exchanges before the compliance date of the SBSEF registration rules.

³ See SEA Release No. 87005 (Sept. 19, 2019), 84 FR 68550, 68602 (Dec. 16, 2019).

⁴ See 17 CFR 249.1701 and 17 CFR 249.1702. Filings must be accompanied by a submission cover sheet.

⁵ Release No. 34-98845, *supra* note 1, at 87156.

⁶ *Id.* at 87288.

⁷ Compare 17 CFR 37.3(a)(1).

⁸ See CFTC Staff Advisory on Swap Execution Facility Registration Requirement, Letter No. 21-19 (Sept. 29, 2021), available at <https://www.cftc.gov/csl/21-19/download#>.

⁹ *Id.*

¹⁰ Compare 7 U.S.C. 7b-3(f) (enumerating 15 Core Principles for SEFs), with 15 U.S.C. 78c-4(d) (enumerating 14 Core Principles for SBSEFs).

¹¹ Release No. 34-98845, *supra* note 1, at 87291-93.

¹² *Id.* at 87290-91.

¹³ *Id.* at 87168.

¹⁴ *Id.* at 87169-70.

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Id.* at 87184-85.

¹⁸ *Id.* at 87187. See also 17 CFR § 37.10.

¹⁹ *Id.* at 87181-82.

²⁰ The SEC has defined the term “US person” in Rule 3a71-3(a)(4), § 240.3a71-3(a)(4) for purposes of the cross-border application of its Title VII rules.

²¹ Release No. 34-98845, *supra* note 1, at 87213.

²² *Id.* at 87216.