New SEF rules – What’s a SEF, What is MAT, and Do I Need to Care?

This month the Commodity Futures Trading Commission (“CFTC”) has certified the first several submissions by Swap Execution Facilities (SEFs) for certain types of derivative products that will need to be traded on SEFs – barring permissible entity or deal structure exceptions or exemptions.

What’s a SEF:
A SEF is an electronic trading platform designed to facilitate automated swap execution amongst large derivative counterparties for standardized swap contracts, intended to increase market transparency and efficiency. The first set of SEF trading mandates take effect on February 17, 2014. These SEF-eligible products are labeled as Made Available to Trade (“MAT”), in contrast to other derivative structures that are not available to be traded on the SEF platform. Despite a rather broad set of originally proposed derivative structure types that were requested to be certified MAT, in a sign of restraint and recognition of market liquidity limitations, the CFTC has given approval to a narrower scope of benchmark and standard swap types to be MAT.

In general, SEF execution requirements only apply to a subset of the swap transactions that are subject to mandatory clearing. As such, for institutions whose derivative activity qualifies for end user exemption from clearing, that activity is also exempt from the SEF MAT rules. In general, banks with less than $10 billion in assets can claim exception from mandatory clearing and therefore will not have to trade on a SEF. Similarly, entities using captive finance and affiliate exceptions can also exempt themselves from trading on a SEF. For entities that do have some of their existing hedging activity that is required to be cleared, only those swap structures that are clearable AND certified as MAT will require SEF execution.

What is MAT:
Last week, the CFTC certified certain interest rate and credit default swaps in USD, EUR and GBP currencies to be MAT. We focus, however, on the first set of MAT certifications for US dollar-based trades. These trades would have to meet the following criteria in order to be considered MAT:

- No notional amortization
- The floating index has to be 3 month or 6 month LIBOR (e.g. 1 month LIBOR is not MAT)
- Trades must be spot starting (T+2) or begin on first 2 IMM dates (e.g. a forward starting trade is not MAT)
There should be no optionality in the trades (e.g. cancelable swaps and caps are not MAT)

Swap maturity must be 2, 3, 5, 7, 10, 12, 15, 20 or 30 years (e.g. a 7.5 year trade is not MAT)

Over time, it is expected the CFTC will continue to certify new swap types as MAT, as the SEFs add liquidity and trading activity of various swap product types.

Do I Need to Care:
If you are a counterparty who is subject to mandatory clearing you must pay attention to whether or not your trades transacted on or after February 17, 2014 fall within the MAT definition. To be sure, any swap structure that does not fit the criteria above, is not considered MAT and does not have to be traded on a SEF. These limitations mean the vast majority of end user hedging structures are non-MAT. Therefore, financial institutions that do have to clear, but are primarily focused on client facilitation hedging activity, are not expected to have many MAT swaps that will be required to be traded on a SEF. In Summary, SEF rules primarily impact the Swap Dealers (SDs), Major Swap Participants (MSPs) and large institutional money managers who were often trading through electronic trading platforms for their standardized (non-customer tailored) swap activity anyway. Nonetheless, for banks and other institutions that currently have some clearable trade activity, it makes sense to be prepared to trade through a SEF if a MAT trade structure does need to be traded.

For entities who do currently clear some of their swap activity, to prepare for this new reality of electronic swap trading starting February 17, 2014, we would recommend taking the following steps:

- Select a SEF platform to connect to
- Review and sign required SEF onboarding documentation
- Notify your Futures Commission Merchant (FCM) of your SEF selection to ensure their connectivity
- Test SEF technology connectivity

If you have any further questions on the new SEF rules, how to set up with a SEF, or on any other derivative related matters, feel free to call, e-mail or visit us at www.derivativepath.com.

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