

FS Regulatory Brief

Derivatives: SEFs – Opening bell sounds

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Overview

The Commodity Futures Trading Commission (“CFTC”) issued three final rules that will move bilaterally traded swaps onto execution platforms that offer many-to-many trade functionality.¹ These rules create the standards for registering and operating swap execution facilities (“SEFs”); for requiring mandatory cleared swaps to trade on SEFs or designated contract markets (“DCMs”) (together, “exchanges”);² and for identifying large notional block trades that can still be executed off exchange. Once mandatory execution rules are in force, counterparties that have to centrally clear swaps also will have to execute them on exchange, not bilaterally.

The three rule sets finalize almost all of the rules proposed by the CFTC regarding SEFs under the Dodd-Frank Act. A fourth proposal, notably absent from the final rules, contained conflict of interest rules that would limit the ability of a SEF owner to execute swaps on its own SEF, among other things. However, even without this rule, the path is set for SEFs to register and, together with DCMs, to become the required execution platforms for those swaps that must be cleared.

¹ “Many-to-many” describes a trading platform in which more than one market participant has the ability to execute or trade swaps with more than one other market participant.

² SEFs and DCMs may offer the same swap products and generally must follow similar rules.

This **FS Regulatory Brief** describes this new regulatory environment for mandatory electronic swaps trading and highlights considerations for the buy-side and sell-side. Key takeaways include:

- Execution on exchange will be required for mandatory cleared swaps only. This means that, at least in the near term, those IRS and CDS that are currently required to clear will be the first to be subject to a trading mandate.
- SEFs must offer many-to-many execution functionality via order books and, if desired, request for quote (“RFQ”) systems that deliver RFQs to at least two and, after one year, three market participants.
- The sell-side should evaluate operational changes to support multiple trade flows, ranging from mandatory on exchange execution and clearing, to voluntary execution or clearing, to pure bilateral. Robust on-boarding functionality will be critical. Global regulatory roll-out will add layers of complexity.
- The buy-side should evaluate arrangements to trade on exchange, as well as to clear.
- Market dynamics and considerations will change as pricing considerations adjust and asset classes migrate on exchange for mandatory *or* voluntary execution.

What trading facilities must register as SEFs (or DCMs)?

Dodd-Frank created the SEF concept as part of the general goal to increase transparency in the OTC derivatives markets. SEFs are regulated trading platforms that provide pre-trade information (bids and offers) and an execution mechanism for swap transactions among eligible contract participants.³ Several current swap trading or matching platforms have been waiting to become registered swap execution venues. The regulatory elements for this change are now in place.

Under the now final SEF rules, any person operating a platform in which more than one market participant has the ability to execute or trade swaps with more than one other market participant must register either as a SEF (or a DCM, under existing rules). To register, the platform must submit documentation with the CFTC establishing that it can operate in compliance with a set of core principles and guidelines.

This many-to-many model is the key feature thought to promote transparency. A one-to-many (single dealer) platform where the sponsoring entity is the counterparty to all swap contracts executed on the platform would not be considered a SEF because it limits the liquidity to a single provider. A SEF must permit more than one bidder to evaluate swap terms from more than one offeror.

A race to register? Many market participants are poised to start operating SEFs as a new business opportunity where first movers may capture volume. Prospective SEFs will be permitted to apply for registration before the effective date of the rule (August 5th) so as to become temporarily registered by then. The deadline for SEF registration is October 2nd. Some take the view that the first to register could take the dominant market position.

³ An eligible contract participant (“ECP”) includes most types of financial institutions or other legal entities/individuals with more than \$10 million in net worth. Only a DCM can trade swaps with a non-ECP under Dodd-Frank.

What swaps may trade on SEFs?

SEFs may list any swap product for trading in accordance with CFTC rules for product approval under Part 40. These rules provide for the approval or self-certification of new products by CFTC registered entities. If a SEF lists a product for trading that must also be cleared (based on a separately issued CFTC clearing determination), the SEF would then file a “made available to trade” (“MAT”) determination with the CFTC. The procedure for making this determination requires the SEF to consider the following factors:

- Whether there exist ready and willing buyers and sellers of the product
- The frequency or size of transactions
- The trading volume
- The number and type of market participants
- The bid/ask spread
- The usual number of resting firm or indicative bids and offers

The SEF’s MAT determination can be submitted to the CFTC either under a rule-approval process or an expedited certification process.⁴ Under the rule approval process, the CFTC will have up to 90 days to review the request; under the certification process, the SEF’s determination would be deemed approved if no action was taken by the CFTC within 10 days. Under either procedure, we believe it is likely that the initial available for trade determinations will be published for public comment and proceed on a slower pace than the 10-day certification process; the CFTC has the ability to stay the certification period and extend review by up to 90 days (with a public comment period), and we expect that they will do so as the new rule rolls out.

Once the CFTC approves a SEF’s MAT determination, then all SEFs or DCMs listing or offering that swap for trading must make the swap available to trade. If the swaps are

⁴ See Part 40 of the CFTC rules.

also required to clear, as discussed earlier, they then must be executed on SEF or DCM. Bilateral execution will no longer be permitted. SEFs must review these determinations annually.

Market point – Concerns exist about the SEF’s incentive to declare products available to trade for commercial reasons and the “first mover advantage.” On the other hand, the SEF review factors (described above) and the requirement for a clearing mandate to precede a SEF MAT determination, will keep products with insufficient liquidity and volume from required trading on exchange.

How will SEF trading work?

This process of listing products on the SEF and then obtaining approval of a MAT determination means that SEFs can offer to trade two categories of swaps. Those that are “Required Transactions” and those that are “Permitted Transactions.” Required transactions are cleared swaps that are declared available to trade (and are not block trades, as described below). They must execute on SEF; bilateral trading no longer will be permitted. Permitted Transactions consist of *any swap* that is listed on SEF but is not a Required Transaction (e.g., not required to clear). This status drives *how* a swap can be traded on SEF.

The SEF rules call for Required Transactions to be executed on an order book and, if desired, with a RFQ system. Permitted Transactions may be executed by any trading methodology offered by the SEF as long as order book trading is offered at a minimum.

Order book: A SEF must offer an order book as its minimum trade functionality for Required Transactions. Order book functionality would allow a broker or dealer to either execute against its customer’s order or execute two of its customers’ orders against each other. Accordingly, the final rules require traders with the ability to execute such orders to wait at least 15 seconds between the entry of the two orders. A SEF may adjust this waiting period based on liquidity, as long as the delay is sufficient

to allow an order exposed to the market and other participants “meaningful opportunity” to execute against that order. This discloses one side of the potential transaction to other market participants before the second side is submitted for execution.⁵

Request for quote system: A SEF may in addition offer an RFQ system in connection with an order book. The RFQ system must provide for a market participant to transmit a request for a quote to buy or sell a Required Transaction to at least two unaffiliated market participants the first year after the final rule, and at least three unaffiliated market participants thereafter. The RFQ does not have to be displayed to all market participants; just to the two or three (or more) participating in the RFQ. The RFQ system can offer one-to-one trading for Permitted Transactions.

Market point – Some argue that the RFQ system carries the risk of a “winner’s curse” for illiquid swaps or large trades. If RFQ information leaks, others may take offsetting positions ahead of the trade; however, the CFTC contends that Required Transactions will have sufficient liquidity to mitigate this concern.

There are several other nuances regarding how Required Transactions must trade on SEF. For example, the SEF must send resting orders from its order books to the RFQ requester at the same time the first responsive bid or offer is received. Buyers and sellers can interface with any SEF functionality via voice, paper or electronic means provided that audit trail requirements are met. A SEF may allow work-up sessions after the original transaction executes so that all market participants can trade an additional quantity of the same instrument at the same price previously executed for a fixed time period.

⁵ This 15 second delay is required to prevent front running. The CFTC noted that requiring brokers to display the pricing of a matched trade for 15 seconds for price improvement would reduce liquidity provided by dealers and give market participants a “free option” to trade ahead.

Block trades – exempt from mandatory SEF execution

The CFTC also issued a final rule for identifying minimum block sizes for large notional off-facility swaps and block trades with its SEF final rules. This rule has two important consequences because block trades are eligible for delays from real-time reporting of data to the public and are excluded from mandatory SEF execution as Required Transactions. The reason for both outcomes is the same: excess transparency around pending block trades can distort market pricing and lead to adverse consequences for the counterparties to the block.

The block trade rules sets up complex criteria for grouping swaps into separate swap categories in order to apply the block trade thresholds. The CFTC explained its methodology for setting appropriate minimum block sizes for each swap categories and established methodologies for setting appropriate minimum block sizes for each swap category. The CFTC included measures to prevent the public disclosure of the identities, business transactions, and market positions of swap market participants.

The rules establish appropriate minimum block sizes for large notional off-facility swaps and block trades. The criteria the CFTC will use are:

- Categorizing together swaps with similar quantitative or qualitative characteristics that warrant being subject to the same appropriate minimum block size; and
- Minimizing the number of the swap categories within an asset class in order to avoid unnecessary complexity in the determination process.

This broad approach to establishing the tenor categories could result in swaps with notably distinct levels of liquidity being grouped into a single tenor category.

The minimum block sizes for publicly reportable block trades and large notional off facility swaps will be based on asset class. The CFTC's block trade rule is effective July 30th and commences with a two-period, phased in approach to implementation. After initially

determining the appropriate minimum block sizes, the CFTC will update the post-initial appropriate minimum block sizes at least once a year. There are various requirements that counterparties to a reportable block trade must follow to benefit from the regulatory delays and exclusions.

Other considerations for SEFs

SEFs will operate as self-regulatory organizations with numerous compliance, risk monitoring and trade practice surveillance requirements. For example, a SEF must have a Chief Compliance Officer ("CCO"), must offer equal access to all market participants, and must monitor rule compliance for itself and its membership. This creates numerous operational and IT tasks and costs that need to be measured against the new environments. SEFs waiting to register may want to review their existing infrastructure and operational plans as well as assess the competitive and strategic issues connected with registering and go-live.

When will SEF trading be mandated?

The SEF rules become effective August 5, 2013. Prospective SEFs will be allowed to apply for registration before the effective date so as to become temporarily registered as of August 5th. But the big question – the date that matters to most of the industry – is the date on which SEF trading will be mandated. As with many things Dodd-Frank, the answer is not simple.

Industry participants will not be required to transact swaps on SEFs (or DCMs) until the later of 30 days after the CFTC approves a made available to trade determination or the date the counterparties are required to clear a particular swap. What's not currently known is when SEFs will seek MAT determinations, and how long the CFTC will take to issue such approvals. Under the most aggressive timeline (and assuming no determinations are deemed approved under the expedited 10-day process), the earliest MAT determination approvals could come in November, with mandated trading in December.

One more regulation to come...

The CFTC has one more proposed rule on SEF governance that is not yet final.⁶ This rule would create limits on owning and trading on a SEF to avoid conflicts of interest. As proposed, it would restrict a bank from having more than a 20% share of any SEF if it also wants to trade on that SEF. This is a critical issue for dealers and liquidity providers who would like to own and trade on a SEF. The SEF rules finalized contain a general conflict of interest rule that does not speak to ownership and membership. The CFTC in this release noted that SEFs should comply with this general rule until further action is taken on the proposal.

Some possible market outcomes

SEF trading is lauded by regulators primarily in the hope that pre-trade transparency will promote competition and therefore pricing improvements. Many critics of the bilateral markets have argued that increased public transparency for swaps could lead to lower bid/offer spreads and reduce overall trading costs. Transparency could improve information asymmetries which critics assume to persist in a bilateral market. By receiving equal access to actionable real-time market prices, market participants may have a higher level of confidence in accuracy and fairness of pricing.

On the other hand, many observers and market participants fear that a one-size-fits-all prescriptive set of rules for what swaps must trade on exchanges, and how those markets must be conducted, risks ignoring key differences between swaps and other financial products. For example, listed futures typically trade much more frequently and in smaller lot sizes than even the most popular swap contracts. Applying the same degree of

transparency around a book of orders for swaps which trade a handful of times per day could have unintended and unpredictable consequences to spreads and liquidity size. An excess of pre-trade transparency around pending trades (e.g., requiring RFQs to be shown to more potential bidders than necessary) could actually harm liquidity and raise risks of market abuses (e.g., front-running) by parties who act on the “free look” at pending transactions.

Our view is that market forces should and will ultimately prevail in determining which SEF market structures succeed and survive, while nonviable structures fail. While naysayers have focused on the downside potential of these rules, they may be discounting the profit motive and value creation incentives that SEF and DCM operators have to create fair and compliant market structures which attract and retain liquidity in exchange traded swaps products.

SEFs also will provide a central source of information and price dissemination at least for Required Transactions. Over time, the accumulation of a reliable time series of actual transaction prices may be a valuable asset to market participants and central clearinghouses.

Transaction costs could increase, at least short term, particularly for larger trades. Operationalizing to trade on SEFs as well as bilaterally could lead to higher transaction costs initially as dealers pass on infrastructure costs and fees for central clearing and execution.

⁶ See Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest, 17 C.F.R. 37.19 (d), 75 Fed. Reg. 63732, 63748 (Oct. 18, 2010) (Notice of Proposed Rulemaking).

Additional information

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