Why SEF Volumes Don't Matter (Yet)

October 10, 2013

On October 2 swap execution facilities (SEF) became official and started reporting trading volumes. While this new level of Greenwich Associates transparency is exciting, today's reported volumes don't really matter. In addition to the lack of reporting standards which complicate doing an apples to apples comparison (i.e. voice vs. electronic, D2D vs. D2C, FRAs vs. IRS), the remaining regulatory uncertainty leaves market participants sitting on the sidelines.

This has led to a supply and demand imbalance. Despite 18 approved SEFs, the largest market participants on both the buy and sell side have very little incentive to change their trading habits. The business is profitable for the former, and the latter is broadly happy with the level of liquidity and service they receive with the current model. And having confirmed directly with the CFTC on Friday (October 11) that no "made available for trading" (MAT) applications have been submit to date , mandatory trading is still months away.

When will the first MAT submission get made? There is very little incentive to be first. It is also a common belief (pending the results of the government shutdown) that the CFTC will not start the clock ticking until after November 1, so it seems unlikely we'd get any MAT determinations before then. (We did also confirm with the CFTC on Friday that they do have personnel in to take the MAT applications, but not someone to post them online). And per my comments on limited natural demand for SEF trading above, the SEFs do not want to upset their customers by bringing the mandatory date any sooner. SEFs want SEFs, major market participants don't want SEFs, and it's just not clear what the CFTC wants. Yes, this is confusing.

But the lack of limited natural demand is only part of the story. The bigger reason behind the unimportance of today's reported volumes lies with the regulators themselves. I discussed in an earlier post why the CFTC needed to provide the industry with some relief ahead of the October 2 deadline. The biggest concern was that leaving Footnote 88 intact would drive trading back to the phone – the exact opposite of the desired result. That can was ultimately kicked down the road until November 1, but de-electronification still hit the market.

Greenwich Associates data shows that before October 2 clients traded 25% of index credit volume electronically – a proportion that IG Index e-trading took years to achieve. But after October 2, one large dealer-to-client SEF reported that electronic trading of index CDS on their platform was down 95% week-over-week; a reduction too large to be blamed on the economy or any other natural market forces. Regulatory uncertainty left many clients concerned they might unknowingly violate rules, so they decided to take the safe route of staying away from SEFs altogether. And then to add fuel to the fire, several dealers stopped providing real-time price feeds as they were just not ready from a legal perspective to execute trades on SEF (more on this later).

Another sign that reported volumes are no indication of future results: in reviewing volume numbers as reported by DTCC, index CDS volumes overall were down nearly 40% whereas single name volumes remained roughly flat. Given that the former was caught up in the SEF implementation and the latter was not, these numbers are telling of the market's reaction to the new rules.

That takes us to November 1, which is the new October 2. In addition to our old friend Footnote 88, there are several open items that the market is wrestling with leading into this new deadline. Uncertainty and complexity surrounding all of the following are keeping traders close to the phone instead of close to the mouse:

Documentation: Each of the 18 SEFs has its own rulebook, along with a host of other documentation that must be signed by each market participant that plans to trade on that venue. If we assume roughly three legal documents per SEF, that means each major dealer needs to sign 54 legal agreements in the next three weeks to assuming they have at least some client demand for every platform. This issue explains why some dealers stopped provided electronic quotes post-October 2 per the above.

Let's not forget that the buy side needs to sign these documents as well, an arguably more monumental task given that many have never become "members" of a trading platform before, leaving the dirty work to their dealers. Another interesting point here: all members of each SEF must be set up in such a way that they can both send and receive RFQs for Required Transactions (those with trading/clearing mandates). Per the CFTC (Section 37.9(a)(3)(iii) if you're following along at home):

"The swap execution facility shall ensure that its trading protocol provide each of its market participants with equal priority in receiving requests for quotes and in transmitting and displaying for execution responsive orders" That's right – your favorite long only mutual fund trading interest rate swaps must technical be able to respond to an RFQ. We like all-to-all markets, but that leap is one that should be taken over months, not over night.

Pre-trade Credit Checking: This is not a new problem, but one for which the perfect solution is still some ways off. When market participants click execute on a SEF, they need a high level of confidence that the trade is done or the whole system will fall apart. This is why pre-trade credit checking is critical. Unfortunately it's not as easy as it sounds.

All of the major SEFs currently have some level of pre-trade credit checking built into the system. The complicated part is how they get those limits from the FCMs and keep them up to date throughout the day. Tera Exchange, for instance, has a risk engine that allows users to monitor limit consumption in real-time. Currently limits come in via their GUI or via file upload, with real-time connectivity in the works. But not everyone is there yet. Let's play the numbers game again: if the top ten FCMs each have 200 clients for which they're providing access to 18 SEFs with an average of two asset classes per SEF, that's 72,000 limits that must be disseminated and kept updated in real-time.

Enter limit hubs. Markit and Traiana are both offering central repositories of limits that turn the web of limit distribution into a hub and spoke. The hubs will either push limits to the SEFs and/or allow the SEFs to "ping" them for limits as needed. This is ultimately where the market will go. MarketAxess, Traiana and JPMorgan did in fact execute a live trade using this infrastructure, and we've confirmed that Tera Exchange along with a few others are well advanced in testing. However a critical mass of connected industry participants is still a few months away.

That takes us back to SEFs managing limits locally on November 1. While the market may be able to function, it will require FCMs to arbitrarily break up client limits by SEFs forcing clients to pick SEFs based on limit distribution. Did I already mention SEF volumes today don't really matter?

The "Void Rule": Up until now, if a clearinghouse or FCM rejected a trade the likely outcome was a trade amendment, followed by a resubmission and ultimately a cleared trade. This method of handling trade breaks is a good one, especially in these early days of clearing, as errors are likely given the pipes and process are all very new.

Apparently the CFTC believes everyone's had enough time to practice, as the new "void rule" says that if a trade gets rejected its dead. Period. In the (Latin) words of the CFTC:

"any trade that is executed on a SEF or DCM and that is not accepted for clearing should be void ab initio". The upside of this rule is you'll know for sure if your trade is good within 10 seconds or less. The downside is, you better not make a mistake or that great price you got an a 10 year USD swap ahead of Bernanke's press release might not be a trade after all.

(There is some debate about this rule in conjunction with the 10 second rule, at a high level regarding when the 10 second clock actually starts. But let's come back to that another day.)

Given all the complexity created view new regulations and their footnotes, an alien from outer space that just landed on Earth might think the CFTC was in fact trying to put the SEFs out of business. A quite ironic thought given the CFTC created SEFs out of thin air via the powers vested in them by Congress. Of course that's not actually the case. And their jobs haven't been made any easier now that the majority of the commission is no longer allowed to come to work.

But until we gain some clarity on the above, SEF trading volumes will not reflect the true market. The waiting game continues.

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