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A Path Forward for Prop Traders in the Swaps Market

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The CFTC is great at sending emails out at inopportune times. In this case it was the 13 no-action letters sent between December 20th chicagoand December 31th while most of the financial world was trying to take a deep breath and enjoy some time off. Apparently Wall Street gets more vacation time than the Commission. Something to bring up with Congress in 2014?

One of those no-action letters – that went broadly unnoticed - clears up concerns raised about the floor trader exemption issued in 2012. The original exemption stated that trades done by registered floor traders do not count towards the $8 billion swap dealer calculation. While at first glance this no-action might seem someone innocuous and technical, a deeper read tells us this letter is in fact a pretty big deal. In short, it opens the door for proprietary trading firms to begin providing liquidity in the cleared swaps market. And in our view, any additional liquidity in the electronically traded, cleared swaps market is a good thing.

First let's revisit an oldy but goody, the definition of Swap Dealer. A CFTC registered Swap Dealer is someone that trades over $8 billion in swaps annually and:

i. holds itself out as a dealer in swaps,

ii. makes a market in swaps,

iii. regularly enters into swaps with counterparties as an ordinary course of business for its own account, or

iv. engages in activity causing itself to be commonly known in the trade as a dealer or market maker in swaps.

This definition has left many proprietary trading firms, many of whom could be a source of new liquidity in the swaps market, on the sidelines. Acting as market makers, prop firms would fall into at least a few of those categories and very quickly surpass the $8 billion volume threshold, forcing them to register as swap dealers. The swap dealer registration process is viewed as too expensive and onerous for most prop traders.

Enter the floor trader exemption. Before we explain, it important to define what a registered floor trader actually is (especially seeing we don't have much "floor trading" going on anymore). Per the Commodity Exchange Act (CEA):

The term "floor trader" means any person—

(I) who, in or surrounding any pit, ring, post, or other place provided by a contract market for the meeting of persons similarly engaged, purchases, or sells solely for such person's own account-

(II) any commodity for future delivery, security futures product, or swap; or

(III) any commodity option authorized under section 6c of this title; or (ii) who is registered with the Commission as a floor trader.

Beyond the chuckles incited by talk of pits and rings c. 1934, the critical part of this definition is "solely for such person's own account". The floor trader exemption included in the Swap Dealer definition of 2012 was intended to help proprietary trading firms come into the swaps market as registered entities without needing to become a swap dealer. But as is the case with most new swaps rules, the devil was in the detail. There were two main problems with the original exemption. Firstly, it wasn't clear how swap trades by or with affiliates of a floor trader would be counted. What if, for example, a proprietary trading firm had one legal entity that was an FCM and one that was a floor trader? Second, the exemption did not allow firms to take advantage of the exemption if they "participate in any market making program" offered by a DCM or SEF. This point alone would keep away most of the major prop trading firms, many of whom are big market makers at the CME and ICE.

These two points – handling of affiliate trades and participation in market making programs – are what is clarified in the new CFTC no-action letter. Affiliate trades are not counted and the floor trader exemption can be used even if the firm is also a registered market maker. The result: the Chicago crowd now has a more clear path as a registered entity into the swaps market.

Before moving on, its important to point out why it makes sense that big bank dealers should need to register as swap dealers and prop trading market makers should not. Put as simply as possible, they do not act on behalf of clients. The intention of the swap dealer designation is to ensure the biggest players in the market are properly overseen, and customers of those institutions have an appropriate level of transparency into those firms and into the market. Given that proprietary trading firms by definition have no customers, they do not fall into this bucket. It is important to keep in mind that all real-time and post-trade reporting rules will still apply, so thinking of them as unregulated as compared to major dealers is inaccurate. And remember, they are registered as floor traders, so an appropriate level of oversight already exists.

While the floor trader relief provides a path forward, it doesn't mean high speed swaps trading will start tomorrow. Firstly, more clarity is needed from the CFTC to differentiate basic trading from actual dealing. Just because a firm makes markets in cleared interest rate swaps, that doesn't mean a hedge trade done in OTC FX should be considered FX dealing. Without more clarity, the latter trade could still subject the firm to a swap dealer designation despite the no-action.

Second, these are quant driven firms that rely on data when deciding when and how to trade. And although there is a lot more swaps market data than there was even 6 months ago, it is still thin compared to other

electronic markets. This creates a Catch 22 – the entrance of quant driven prop firms into the market will generate a lot of the bid/ask data needed for automated trading to increase, but many of these firms won't enter the market until that data is already available.

Conversely, this lack of data could actually present opportunities for first movers. For those that have developed proprietary pricing technology, spotting market dislocations and trading against them could prove quite successful given participation in such strategies will be thin early on. And in the early days of the SEF mandate, pricing dislocations are likely to be plentiful.

While major dealers will always be the biggest sources of liquidity, to make the new model work we need new entrants with new business models and new ideas. The CFTC should do everything it can to encourage anyone who wants to add liquidity to this market to do so, including proprietary trading firms. The floor trader no-action letter doesn't mean Chicago will enter the swaps market en masse next month, but it will certainly get the ball moving a lot faster.

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www.greenwich.com | ContactUs@greenwich.com

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