SEF Day 1: A Big Deal but Not a Big Bang

February 10, 2014

Tuesday February 18th is certainly a big deal. Requiring swaps to trade on registered platforms was one of the primary tenets of derivatives reform since shortly after the Lehman big bang theory bankruptcy, and finally the day has arrived. This is the first regulatory driven change since 2008 that will deeply impact the way sell side and buy side traders interact with one another. It will also overtime cause dealers to rethink business lines that are no longer profitable in the new world.

This is a US rule, yes, but the implications are most certainly global. The fact that this is first swaps trading mandate implemented globally makes it historic, and US extraterritoriality rules ensure the rule's impact will go beyond US borders. And on a personal note, having watched the creation of this new market structure from the start I'm excited that the band-aid will be finally pulled off.

Despite the importance and symbolism of the February 18th milestone, it will not prove to be the big bang that many are expecting.

But before I get to why, its important to address whether or not the February 18th implementation date will actually stick. While of course its too early to know for sure, and numerous other big dates have been pushed back at the last minute (remember Category 1 clearing?), this one looks like it will go ahead as planned. The major outstanding issues appear to be packaged trades, bunched order allocation and SEF jurisdiction.

The Open Issues

Whether or not packaged trades should be included in the MAT determination has been a source of debate since October 2013. The question: if you trade a swap spread over Treasuries (which is quoted at a single price) should the IRS leg be required to clear? The market is saying no, and just before I hit PUBLISH on this blog post the CFTC provided relief from package trades until May 15. The relief eases an operational burden on Day 1, but I don't fundamentally agree with the arguments against. In the bilateral world there was no legging risk. The trade was done at one price with one dealer. With the swap leg cleared, you could in theory end up with just the Treasury leg of the trade if the swap fails to clear. This worry is a big over exaggerated. The chances of this happening, taking into account pre-trade credit checking, are slim to none. But that said, I'm not the one that has to deal with that risk day to day.

Bunched order allocation is not a new topic either. This has been discussed for a year or more at this point. How can a bunched order clear immediately if the allocations and hence the final clearing FCMs are not yet known? Answers to this problem exist, they're just not institutionalized. Stand-by FCMs are slowing signing up select accounts and clearinghouses are working out the technology. This issue is not a small deal, but not one that should hold up SEF trading given we've been clearing bunched trades for over a year.

Last and most complicated is the SEF jurisdiction issue. SEFs are required to via their rulebook have jurisdiction over the end client trading on the SEF. For asset managers trading on behalf of dozens if not hundreds of clients this becomes very complicated. Should a SEF be able to sanction a pension fund because a trader at the asset manager investing their assets breaks one of the SEFs rules? This is very much a legal question and so one I will not try to answer. Suffice to say this is a complex issue with a tough road towards middle ground. Far as we can tell most investors are going ahead in good confidence with their chosen SEFs and signing the rulebooks. The CFTC has in fact provided some guidance on this issue but I suspect not exactly what the market had been hoping for:

…while Rule 37.202(b) requires that market participants trading on a SEF consent to its jurisdiction, it is a reasonable interpretation that such consent need not be obtained through an affirmative writing. DMO stated that at this time a SEF may comply with Rule 37.202(b) by providing in its rulebook that any person initiating or executing a transaction on or subject to the rules of the SEF directly or through an intermediary, and any person for whose benefit such a transaction has been initiated or executed, consents to the jurisdiction of the SEF.

I read this as market participants don't need to sign that the SEF has jurisdiction, but the SEF has jurisdiction anyway. We have no heard the end of this one.

Our bottom line – we hope and expect the CFTC to issue the guidance needed on the remaining issues to leave market participants at least temporarily comfortable enough to go ahead with the swaps trading mandate on Monday.

Not a Big Bang

To understand why Monday won't be a big bang we need to first look at the expected long term changes swap trading mandates are expected to bring to the market. In no particular order: new liquidity providers, new swaps users/investors, order book trading and all-to-all trading. We expect to see very little of any of these things on day 1. Day 1 will see heavy use of traditional RFQ for the relatively narrow set of mandatory products. Especially for traders accustomed to using RFQ for US Treasury trades on Tradeweb and Bloomberg (market share leaders for UST per our upcoming research), this will not prove a major change. Dealer to dealer trader will remain at the major inter-dealer brokers who employ a voice RFQ model, also a very small leap from current practice. As for new liquidity makers and takers, conversations with these firms and logic tells us that they will not test the waters on day 1 when risk of market disruption is at its highest. To that point, even investors already in the market are positioning themselves in such a way that they can slow down or stop trading if things go poorly.

The swaps trading mandate is monumental no doubt. Reported SEF volumes will rise from current levels as ways around the rules shrink with mandatory trading in place. But the market isn't going to change overnight. This is still going to be a steady process over the coming months that will see the above expected trends begin all the while the mandatory product list grows. So for all of you that need to work this weekend and be in before dawn on Tuesday (remember Monday is President's Day) – good luck! The day has finally come.

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