

**SWAP EXECUTION FACILITIES:  
CAN THEY IMPROVE THE STRUCTURE  
OF  
OTC DERIVATIVES MARKETS?**

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**Executive Summary**

This paper discusses important issues associated with mandating the use of swap execution facilities (SEFs) for executing certain OTC derivatives products. It asserts that such mandates should be structured in a way that preserves the OTC derivatives market's strengths while addressing its weaknesses, presents a set of desirable SEF characteristics to meet this objective and identifies relatively modest infrastructure and transparency benefits that SEFs might bring. The paper also analyzes the proposed rules of the CFTC and the SEC required by the Dodd-Frank Act (DFA) and makes recommendations to improve, in particular, the CFTC proposals in a manner consistent with a reasonable reading of DFA.

Structural changes to the OTC derivatives markets should be adopted flexibly to enable them to adjust and remain liquid. Changes should be carefully constructed to allow end users to retain (and possibly increase) their ability to effectively manage risk. To achieve these objectives, SEFs, at a minimum, should:

- Provide maximum choice in trade execution to market participants;
- Promote pre- and post-trade transparency while maintaining liquidity;
- Have reasonable, tailored and product specific block trade exemptions.

In addition,

- Rules should be flexible enough to allow business models to evolve over time;
- Products required to be traded in SEFs should be limited to liquid, mature products;
- Rules should not be simply imported from other, fundamentally different markets but should take into account the nature of the derivative products traded and the relative sophistication of the market participants.

To provide a useful context when examining the likely impact of SEFs on the trading of OTC derivatives, we start with an overview of the current market structure (Section I). Section II examines the market's strengths and weaknesses from the perspective of both users and regulators and presents several desirable characteristics of SEFs which should strengthen the market. The OTC derivatives market is compared with that of futures in Section III and

fundamental differences in their structures are highlighted. We then examine the CFTC and SEC proposed rules and critique provisions likely to have a negative impact on the market's flexibility and liquidity (Section IV). The last section contains recommendations for improving the proposed rules.

# I. Current Market Structure for OTC Derivatives Products

## Market Size and Trading Frequency

The OTC derivatives market has grown tremendously in terms of product range and size since its inception 30 years ago. The market now consists of five primary asset classes: interest rates, credit, commodities, equities and foreign exchange. However, other forms of derivatives, such as weather, longevity and catastrophe, are also used.

Most analysts use figures produced by the Bank for International Settlements (BIS) to describe the size of the market. As of June 30, 2010, the BIS estimated the market was \$583 trillion in size as measured by the aggregate notional amounts of contracts outstanding. This estimate, however, is somewhat misleading. Many analysts exclude foreign exchange (\$63 trillion) from the total as foreign exchange forwards pre-date other products by decades. The BIS estimate also splits in two swaps executed between dealers that are subsequently cleared by the London Clearing House (LCH). This essentially double counts these transactions. The LCH was clearing \$229 trillion as of June 30, 2010 and so the total is overstated by \$114.5 trillion. Another adjustment is to update the Credit Default Swaps (CDS) market totals for current data from the DTCC trade repository. If these adjustments are made, the marketplace is reduced to the following components:

A. Interest rate products:	\$364 trillion
B. Credit products:	\$27 trillion
C. Commodity contracts:	\$3 trillion
D. Equity products	\$7 trillion
Adjusted Total	\$401 trillion

In all, interest rate products account for approximately 90% of the marketplace by notional. While notionals outstanding are very large<sup>1</sup>, the number of transactions executed in any day is quite modest. For all interest rate products, some 5,500 trades are executed on an average day globally in over 20 currencies. CDS new trade volumes typically run approximately 7,000 per day. Only a small group of CDS reference names are traded more than 20 times a day. Over 4,000 names have traded with each name having multiples of 40 contracts each<sup>2</sup>.

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<sup>1</sup> The notional amount is the basis on which payments in a derivative contract are calculated. Actual net market value of future payments, using current market conditions, referred as the mark-to-market value is a better measure of the risk embedded in the contract and, almost always, a fraction of the notional. Aggregate mark-to-market value is about \$25 trillion.

<sup>2</sup> Volumes fluctuate significantly over time. There were 21,690 new credit derivative trades (13,951 Single Name and 7,739 Index and Index Tranches) executed the week ending on March 11, 2011. There was an increase of 19,438 trades in TriOptima's repository during the week ended on February 25, 2011. It is estimated that this increase represents approximately 80% of all trades in rate products completed, globally, in the period. Information on trading volumes for credit derivatives, rate derivatives, bonds and futures can

## **Bilateral Execution / Counterparty Credit Risk**

Swaps are generally traded on a bilateral basis, i.e., between two counterparties. Most derivatives are executed between a bank dealer and its clients or between two dealers who seek to hedge risks they have taken or as a means of taking on new risk. In all, there are 14 very large global dealers but another 20 or so large banks are active in certain major markets. An exception to the bank dealer market is the commodity derivatives market where non-bank dealers are quite common. Dealers in the OTC derivatives markets act as principals, i.e., assume the market and credit risks associated with the trade until its maturity. In the futures markets, futures commission merchants (FCMs) act as agents for their clients.

OTC derivatives contracts are typically multi-year contracts and involve assumption of credit risk as market rates move. For example, if a counterparty receives fixed rates in a 5% environment for 10 years and the interest rate market moves to 3% in three years, the counterparty will be exposed to its client or bank to make good on the now off-market (in the money from the counterparty who receives the fixed rate payments point of view) derivative for the remaining life of the transaction. As can be seen, this credit relationship is, potentially, as long as the longest derivative contract between the two counterparties. To streamline and standardize documentation, master derivative agreements have been developed, governing a large percentage of all contracts. These agreements typically contain netting provisions, enabling counterparties to offset in the money trades (assets) against those out of the money (liabilities), thereby reducing exposure substantially. A majority of these master agreements also call for collateral to be exchanged between the parties to further reduce the netted exposure. These master agreements are negotiated with care to ensure each side is properly protected.

### **Clearinghouses**

Certain derivatives contracts – plain vanilla interest rate contracts, many credit indices and nearly 200 CDS single name reference entities – are eligible to be cleared by clearinghouse members. In these transactions, the parties usually present a transaction to a clearinghouse for clearing approval. If the clearinghouse accepts the transaction, the bilateral contract is novated and the clearinghouse becomes the counterparty to each side of the transaction. The clearinghouse requires both initial margin and variation margin to protect itself.

Clearinghouses can bring significant benefits. The default of Lehman Brothers in 2008 provides an important example. At that time, the London Clearing House was able to liquidate over 60,000 trades representing over \$8 trillion of notional value. Trades cleared by the two largest clearinghouses, the London Clearing House and the InterContinentalExchange ("ICE"),

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be obtained from the DTCC ([http://www.dtcc.com/products/derivserv/data\\_table\\_iv.php](http://www.dtcc.com/products/derivserv/data_table_iv.php)), TriOptima (<http://www.trioptima.com/repository>), FINRA (<http://cxa.marketwatch.com/finra/BondCenter/Default.aspx>) and the CME (<http://www.cmegroup.com>) respectively.

are almost entirely comprised of dealer to dealer trades.<sup>3</sup> Both of these have developed the means to clear transactions for clients of clearing members but little business has been executed to date.

### **Users of Derivatives Markets: Institutions**

Who uses OTC derivative products? Virtually all non-dealer business is executed by large institutions - banks, investment managers, other financial firms, corporations hedging risk, and other similarly sophisticated market participants. While there are thousands of end users of OTC derivatives, perhaps 500 entities are active in global interest rates and a somewhat lower number of participants are active in credit products. Wider use of clearinghouses for over-the-counter derivative products has the potential to improve market resilience by lowering counterparty risk and increasing transparency.<sup>4</sup>

### **Pricing Derivative Products / Transparency**

Nearly all users of OTC derivatives products have relationships with multiple dealers and two or more dealers are typically put into competition for each deal. Pricing is very competitive for standard transactions for creditworthy counterparties. This competition results in very narrow spreads for the most liquid products: plain vanilla interest rate swaps, many interest rate option products, credit indices and the most liquid single name CDS. Moreover, OTC derivative users are typically very sophisticated and experienced and are fully capable of executing less competitive transactions to their benefit. In fact, end users sometimes "choose not to broadcast their transaction details to multiple participants" in order to have access to efficient and cost effective hedging.<sup>5</sup> Recent surveys confirm that end users, by and large, are very satisfied with the service, including pricing, they get from dealers.<sup>6</sup>

Illustrative of these points is the blind test sponsored by ISDA in 2010<sup>7</sup>. In the test, three large investment managers asked groups of three dealers for firm pricing on five interest rate swaps denominated in USD or Euro. (Each investment manager had a unique set of swaps.) Interest rate swaps are quoted in basis points, i.e., hundredths of a percent. The average winning

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<sup>3</sup> For a variety of reasons, a client transaction may be included in the "dealer to dealer" clearing metrics. Due to standard practices in the OTC derivative markets, clients may assign their role in a dealer-facing trade to another dealer while unwinding an open position, or may use a dealer to intermediate a trade when transacting with other dealers. In both instances, if a clearing solution is available, such client originated trades end up as dealer to dealer trades in clearing.

<sup>4</sup> *Central counterparties for over-the-counter derivatives*, S G Cecchetti, J Gyntelberg, M Hollanders, BIS Quarterly Review, September 2009, 45-58.

<sup>5</sup> See the Coalition for Derivatives Users letter to the CFTC dated March 8, 2011.

<sup>6</sup> ISDA End-User Survey: Interest Rate Swaps, October 2010.

<sup>7</sup> "Interest Rate Swap Liquidity Test" - a report sponsored by ISDA and conducted by Atrevida Partners in conjunction with market participants in November 2010.

quote for the 15 swaps was a mere one tenth of a basis point over the middle of the market at the time the quotes were sought.

In addition to obtaining competitive pricing on transactions, users of derivatives typically have screens from dealers, containing bid and offer indications for standard transactions. Vendors such as Bloomberg also provide composite pricing screens. A number of dealers currently have the means to permit electronic execution of transactions, primarily in interest rates swaps but also increasingly in other products. Inter-dealer brokers typically have live pricing screens, enabling dealers to execute electronically. There are also a few electronic platforms, such as Tradeweb, that are open to end users.<sup>8</sup>

### **Operational Infrastructure and Valuation**

The operations underpinning OTC derivatives require a sophisticated set of systems and staff to cope with the deal flow. The industry has largely migrated to electronic confirmations of transactions, thereby reducing legal and documentation uncertainty that had persisted for the first two plus decades of the industry's life. Most large firms employ straight through processing, meaning once the trade is entered, everything else is done without human intervention.

Dealers and their clients need to value positions on a daily basis. Market prices, obtained from screens, are used as inputs to valuation models which calculate prices for existing positions. Theory behind the valuation models becomes generally accepted over time but changes do occur as has been witnessed in the interest rate swap market in just the last few years. Dealers need robust systems to price a large number of transactions for their books and records, risk management and daily reports for clients. Dealers also need significant analytical resources to ensure valuation techniques are adequate.

### **Summary**

OTC derivatives are complex products, typically traded by professionals at large institutions, involving unlimited variations of terms, market risk and credit risk, that can be tailor-made to match the users' exact requirements, and requiring significant systems, analytical and legal support. In the next section, we will discuss how OTC derivatives are performing - what works, what goes wrong and, more importantly, what could go wrong.

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<sup>8</sup> An electronic platform originally developed to facilitate bond trading. Tradeweb is owned by Thomson Reuters and 10 leading dealers.

## **II. Strengths and Weaknesses of the OTC Derivatives Market**

### **Strengths**

The OTC derivatives market has been remarkably successful in the 30 odd years of its existence. This success is directly related to: a) the flexibility of the product itself; b) the importance of the dealer-client relationship; c) market liquidity, d) legal certainty; e) credit risk management mechanisms the industry has developed; and f) the confidentiality of contracts.

#### **Product Flexibility**

The product is completely flexible. Products can be devised to manage exactly any specified risk - whether it be exposure to interest rates, inflation, commodities, weather, catastrophe, equities, credit, etc. The exposures do not have to be general. They can be as specific as the counterparties to transactions wish. Risks can be managed in scores of currencies with hundreds of swap and option products with virtually any start or maturity date.

#### **Dealer-Client Relationship**

The dealer-client relationship is central to the derivatives marketplace. Dealers take exposure to the risks that their clients want to hedge. Dealers also assume risk when clients put on new positions by taking the opposite side in the trade. These risks include not only outright exposure to the principal product or market but also "basis" risk – mismatches of dates, rate indices, frequency of payments, delivery venues, the list goes on and on. Managing portfolios of risk requires large investments in risk systems, skilled personnel and infrastructure as well as large pools of dedicated capital. This dedicated capital, from some of the world's largest financial institutions, enables users of OTC derivatives to obtain very competitive pricing on tremendously large transactions. These users range from sovereigns, supnationals, corporations and investment firms to smaller companies and banks which are also able to take advantage of competitive pricing. These market making activities on the part of derivative dealers provide significant benefits to U.S. corporations and other end-users – benefits that are ultimately passed on to the broader economy and U.S. consumers.

#### **Market Liquidity**

With large pools of capital dedicated to making prices, users can transfer large amounts of risk, frequently in highly customized fashion, in a single transaction with minimal price disturbance.

## **Legal Certainty and Credit Risk Management**

As shown in the previous section, the derivatives market amounts to hundreds of trillions of dollars of notional amounts. The industry has managed legal risk and counterparty credit risk by developing and using standardized contracts and confirmations, employing netting in over 50 countries and encouraging the use of collateral to cover market risk. Netting alone has reduced credit risk by 85%, according to the BIS, from nearly \$25 trillion to less than \$4 trillion and collateral has reduced it significantly more. The market could not possibly exist in its current state without these risk mitigants in place.

## **Confidentiality of Contracts**

Derivative contracts are confidential agreements between two counterparties. This protects both the dealer that puts capital at risk as well as the client. The dealer can offset risk without a knowing market trading against its position. The client can protect its risk management or investment programs if they need to be executed over time as well as gain the benefit of better pricing because of the dealer's protection.

## **Weaknesses**

In spite of its success and of its ability to provide the most flexible tools for risk management, the complexity and lack of transparency to regulators in the OTC derivatives market have been blamed for increasing systemic risk and for having an operational infrastructure that could be significantly improved. Critics of the OTC market have also cited lack of price transparency as a weakness.<sup>9</sup>

## **Complex Risks**

The financial crisis revealed certain safety and soundness issues that OTC derivatives might create in financial markets. The first such issue was the extent of complex derivative risk in the marketplace – the AIG phenomenon. AIG was not alone, nor was this risk only taken in derivative form. Complex mortgage risk was taken by many market participants in cash as well as derivative form. This risk was not properly understood or managed by participants who bought the mortgage bonds or who provided the mortgage protection. Dealers who bought protection did not properly exercise appropriate counterparty risk management measures as the risks were much larger than expected.

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<sup>9</sup> *Policy Perspectives on OTC Derivatives Market Infrastructure*, D Duffie, A Li, and T Lubke, *Federal Reserve Bank of New York Staff Reports*, no. 424

## **Interconnectivity - Systemic Risk**

The second safety and soundness issue was the interconnectivity among dealers. Dealers have many points of transactional contact with other dealers, including, of course, OTC derivatives. It was not clear *a priori* how dealers might manage the risks of unwinding OTC derivatives positions they had with a defaulting dealer, even if the exposures were collateralized. Position and counterparty transparency was not available to the regulators. A related issue was the risks dealers posed to end users. Although material, this risk is not as large in aggregate. For example, the losses sustained by non-financial corporations in the Lehman bankruptcy that were solely caused by OTC derivatives were relatively modest: only four have filed claims in excess of \$20 million against Lehman's derivative subsidiaries<sup>10</sup>.

## **Operational Infrastructure**

A different type of safety and soundness concern with OTC derivatives has always been present as a result of the infrastructure of the marketplace. Unlike exchanges, clearinghouses and other organized trading venues, the OTC derivatives market is what its name implies - over the counter. Each dealer and each user must construct its own infrastructure to manage its positions. The infrastructure ranges from accounting and payment systems to valuation models, collateral processes, portfolio reconciliations, etc. Regulators naturally believe one centralized family of systems is better than dozens, if not hundreds of independent families, any one of which could potentially create financial havoc if it failed.

## **Transparency**

Most active users of OTC derivative products have access to dealers screens and vendor pricing services. In some OTC derivatives markets, customers may actually have access to pricing information comparable to the dealers as price aggregation services are available. However, because users do not see the prices where transactions are actually being executed, some users may be paying more than others for comparable products. To a large extent, users have not complained. They have become comfortable operating within the marketplace, soliciting prices from multiple dealers for virtually all their requirements. Nonetheless, additional transparency might be beneficial if it does not come at the cost of less liquidity and, therefore, higher prices. A related issue is ease of access to the marketplace. Should a market require participants to have multiple trading relationships if a central market can exist that requires only one such relationship?

Lack of transparency increases the room for market abuse and manipulation. In addition

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<sup>10</sup> See <http://chapter11.epiqsystems.com/LBH/claim/SearchClaims.aspx?rc=1>

to needing transparency to monitor risk in the marketplace, regulators require transparency to prevent market abuse and manipulation.

## **Strengthening the Market - Execution Platforms**

DFA addresses the significant safety and soundness issues primarily by requiring mandatory clearing for OTC derivatives as and when clearing becomes available. This will be required for all but non-financial end users. A similar proposal has been made to cover European markets. Clearing will not be available for complex derivatives as these products do not have the liquidity or standardization required for safe clearing. Complex risk will be visible through trade repository data (also mandated by DFA and its European equivalent) and better regulatory oversight. Trade repository data will also help regulators identify concentrations of counterparty and market risk.

Structural changes to the OTC derivatives marketplace that do not address safety and soundness need to be carefully constructed so as to preserve the market's strengths while addressing its weaknesses. When trade-offs need to be made, flexibility of approach is recommended to enable markets to adjust and remain liquid. Regulators have recognized that there are a number of different electronic trading models that could potentially be used for derivatives trading.<sup>11</sup> What then should a SEF be? In our view a SEF should be an effective marketplace offering derivative users broad choice in trade execution at very low cost. SEFs should be structured in ways such that end-users retain (and possibly increase) the flexibility they now have in executing trades and their access to the liquidity needed to effectively manage their risk. SEFs should:

- Provide maximum choice in trade execution to market participants. Members should not be constrained in their ability to implement their trading strategies by market rules;
- Provide pre- and post-trade transparency while maintaining liquidity.
- Have reasonable, tailored, and product specific block trade exemptions to preserve market liquidity;
- Grant access to a broad range of qualified market participants. Access rules should be objective and applied impartially;
- Have the ability to comply with the Core Principles<sup>12</sup>; and
- Have direct connectivity to trade data repositories.

It is also essential that individual SEFs are not discriminated against by central clearing organizations in terms of access and pricing.

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<sup>11</sup> See *Report on Trading of OTC Derivatives* by the Technical Committee of The International Organizations of Securities Commissions (IOSCO), February 2011, for an excellent, comprehensive discussion.

<sup>12</sup> As defined in DFA.

### III. The Markets for OTC Derivatives and for Futures Contracts

Market structures and practices evolve over time, driven by the needs of market participants. Where there is the potential for frequent trading of a financial (or commodity) asset, with a large number of buyers and sellers, one or more venues emerge to promote such trading by facilitating the execution of transactions by standardizing commercial terms, developing processes to complete transactions quickly and accurately and mitigating credit and other risks. Some of these markets evolve into exchanges. Much of the trading in futures contracts and a substantial portion of the trading in equities is now done on regulated exchanges. Successful exchange-traded products rely on relatively active order submission by many buyers and sellers creating high transaction flow.

Exchange-traded markets offer no guarantee of trading liquidity as evidenced by the high percentage of new exchange-listed products that regularly fail to enjoy active trading. For those contracts that do become liquid, exchanges allow a broad range of trading customers (including retail customers) meeting margin requirements to transact a small number of highly standardized contracts in relatively small amounts. As a result of the high number of market participants and the relatively small number of standardized instruments traded and the credit of a central counterparty clearer, liquidity in exchange-traded markets is relatively **continuous** in character. However, average ticket size is quite small and users often need to take significant market risk to execute large positions in smaller pieces over an extended period of time.

At the other end of the spectrum are markets such as those for OTC derivatives. Here, the number of potential buyers and sellers is relatively small, almost all of which are institutional, featuring a broader array of less-standardized products. Trades are typically much larger in size and much less frequent. Liquidity levels are highly variable and depend, to a very large extent, on a dealer making prices for clients. This, of course, is how the OTC derivatives markets started and remain today. Participants in these markets are very limited in number, almost all of them are institutions and they can obtain an almost endless variety of products. Trading in virtually all products is infrequent at best but the average size of trades dwarfs the size in the exchange-traded markets. Indeed, users often turn to the OTC markets because they cannot execute large enough size in the exchange-traded markets in one trade.

The table in the next page summarizes the main differences between the futures markets and the OTC derivatives markets.

## OTC Swap Market vs Listed Futures Markets<sup>13</sup>

<u>Characteristic</u>	<u>OTC Swaps</u>	<u>Listed Futures</u>
Trading Counterparties	< 1,000	>> 100,000
Retail Participation	None	Significant
Daily Trades	< 20,000	> 1,000,000
Tradable Instruments	>> 100,000 <sup>14</sup>	< 1,000
Trade Size	Very Large	Small
Market Structure	Bilateral (OTC)	Exchange

Of course, the two structures described above are not the only ones that have emerged. Trading in US treasuries for example, arguably one of the most liquid financial instruments in existence currently, is conducted in a number of marketplaces with different structures. Almost all of the trading in the so-called "on-the-run" treasuries, those most recently issued and most liquid, is conducted in electronic trading platforms like Tradeweb and BrokerTec where customers can access multiple large providers of liquidity. A substantial portion of trading in older, "off-the-run" treasuries is still done through wholesale brokers. Retail investors almost invariably trade with their brokerage. There is no requirement that any trades be made entirely on electronic platforms.

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<sup>13</sup> See *Block Trade Reporting for Over-the-Counter Derivatives Markets*. ISDA/SIFMA January 18,2011.

<sup>14</sup> Inclusive of all tenors, strikes and duration.

## **IV. Swap Execution Facilities: Proposed Rules**

Derivatives regulation is being addressed on a global basis. In the United States, DFA has been enacted. It delegates authority over the interest rate and commodity derivatives markets to the CFTC and the CDS and equity derivatives markets have been assigned to the SEC. (The CFTC also has responsibility for derivative products related to certain indices of credit and equity instruments). Across the Atlantic, the European Market Infrastructure Regulation ("EMIR") focuses on clearing and trade reporting while Markets in Financial Instruments Directive (MiFID) deals with, among other things, electronic trading requirements. The International Organization of Securities Commissions (IOSCO) has recently published a study<sup>15</sup> which analyzes the costs and benefits associated with increasing organized platform trading of derivatives. The study provides a comprehensive discussion of considerations that need to be addressed in making rules regarding electronic trading.

### **DFA**

With respect to electronic trading, DFA requires that derivatives subject to mandatory clearing be executed on a SEF provided the derivative is made available for trading there. The electronic platform must be either a Designated Contract Market or a Swap Execution Facility . A SEF is "a trading system or platform in which multiple participants have the ability to execute or trade by accepting bids and offers made by multiple participants in the facility or system, through any means of interstate commerce".

DFA is intended to be implemented by rule-making of the CFTC and the SEC. The agencies must, of course, start with the plain language of the statute. In this respect, it does not appear that a single dealer platform could qualify as a SEF. While multiple parties might have the ability to execute through such a platform, they would not have the ability to accept bids or offers made by multiple participants. They could only deal with the dealer. Is this a reasonable outcome? It does facilitate access to competitive bids or offers but it is hard to see why every SEF must be created the same way. Real-time reporting (except for block trades) will provide transparency of pricing. As long as every participant that becomes a client of a member of a clearing house has access to a SEF that does permit multiple to multiple execution, it is hard to see the benefits of requiring every SEF to have this condition.

### **CFTC**

The CFTC has issued<sup>16</sup> very specific rules regarding electronic trading. First, with respect to determining which products are available for trading, it delegates to the individual SEFs the

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<sup>15</sup> Op. Cit.

<sup>16</sup> "Core Principles and Other Requirements for Swap Execution Facilities" published in the Federal Register on January 7, 2011 p 1214-1259.

determination of whether a derivative product was made available for trading. If one SEF has made that determination, all SEFs would be required to treat the swap as made available for trading as well. This poses a number of issues. It does not set out any specific criteria to determine whether a derivative product has the liquidity to trade. The IOSCO study points to two characteristics of products that need to be addressed in determining which products should migrate to platform trading. The two characteristics are standardization and liquidity. It goes on to set out elements of standardization and how to assess standardization using 10 different factors. It further examines liquidity, looking at the numbers and types of participants, each product's characteristics and transaction size and frequency. The CFTC does not specify such an assessment. The CFTC should state that a contract subject to mandatory clearing does not automatically make it available for trading and that the contract must also meet minimum liquidity and standardization characteristics.<sup>17</sup> The proposed rule creates a misalignment of interest, as SEFs will presumably be established as commercial enterprises. They will have every incentive to declare they have made a product available for trading in order to capture market share by steering trading onto their platform, even if the product trades very infrequently. Furthermore, if a product trades very infrequently and every trade executed is known to the entire market as a result of SEF execution, participants will be very cautious in taking on positions. The result will be less liquidity and worse pricing for users as the dealer-client relationship will have been needlessly damaged. The easiest way to eliminate this conflict of interest and its negative implications would be for the CFTC to make the "available to trade" determination - subject to public notice and comment.

A second proposal from the CFTC requires that SEFs either be Order Books or request for quote (RFQ) facilities. This is an unnecessarily narrow reading of the statute. It is difficult to see the advantage of requiring only two types of facilities to qualify as SEFs when other types of facilities might easily accomplish the goals of DFA. The CFTC further states that a participant utilizing a RFQ must send the request to at least five participants. This appears to be another example where the CFTC is being more precise and restrictive than it needs to be. The DFA states that participants must only have the ability to accept multiple bids or offers - not that they are required to ask for them. Requiring bids or offers from five dealers may make dealers hesitant to price the transaction aggressively as at least four other market participants will know of their winning position.<sup>18</sup> There may be other swaps that represent hedges for confidential transactions and should not be presented to five dealers. The five dealer requirement limits how

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<sup>17</sup> IOSCO, *Op. cit.*, p22.

<sup>18</sup> The SEC is aware of this problem: "However, broadly communicating trading interest, particularly about a large trade, may increase hedging costs, and thus costs to investors as reflected in the prices from the dealers." See 17 CFR Parts 240, 242 and 249 [Release No. 34-63825; File No. S7-06-11] *Registration and Regulation of Security-Based Swap Execution Facilities*, p17.

participants operate in markets when it does not serve clear purposes. The requirement is bound to reduce liquidity.

The CFTC indicates that all contract participants have impartial access to its markets and services. This seems to preclude a business model designed for wholesale participants only. The IOSCO study indicates that European regulators permit platform operators to categorize clients and to make rules appropriate for the category. This does mean that different clients may be treated in different ways. It does not seem necessary to prescribe that the business model of each SEF must ensure that all types of clients have equal access to it.

We also note that the proposed rule that each SEF know the full market position of every participant so that it is able to block any execution that would break a position limit appears to provide little value and, in this case, would be very difficult to implement.

## **SEC**

The SEC has also proposed rules<sup>19</sup> that would govern OTC derivatives under its jurisdiction. The SEC approach is principles-based and is in general far less prescriptive than that of the CFTC. It does not specify that SEFs must either be Order Books or RFQs. It does not indicate how many participants must be asked for quotes. It does not require "unfettered access to any and all persons". The proposed rules require however that in SEFs "that operate both central limit and a separate RFQ mechanism, the SEF's systems would be required to ensure that any trade to be executed in the RFQ mechanism interacted with any existing firm interest on the central limit order book...". In addition, the SEC does require each SEF to know the full market position of every participant just as the CFTC does.

## **European Proposals**

The European Commission has recently issued a consultation paper<sup>20</sup> outlining future policy initiatives regarding the Market in Financial Instruments Directive (MiFID). In it, the Commission considers, among other things, the issue of trading standardized OTC derivatives on exchanges or electronic trading platforms where appropriate, as part of its efforts to ensure efficient safe and sound derivatives markets. The approach is principles-based rather than prescriptive, pointing to a more flexible market environment than the U.S: "MiFID<sup>21</sup> is not prescriptive about where trades must be executed and provides flexibility and a choice for investors about where and how they wish to execute trades".

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<sup>19</sup> Op. Cit.

<sup>20</sup>European Commission Public Consultation - *Review of The Markets In Financial Instruments Directive (MiFID)* 8 December 2010

<sup>21</sup> MiFID - Markets in Financial Instruments Directive

To address evolving market practices and technological developments and mitigate harmful regulatory arbitrage, the Commission proposes to introduce the concept of an *organised trading facility* with a broad definition in MiFID to suitably regulate all organized trading occurring outside the current range of MiFID venues. This definition would capture any facility or system operated by an investment firm or a market operator that, on an organized basis, brings together buying and selling interests or orders relating to financial instruments. This would cover facilities or systems whether bilateral or multilateral and whether discretionary or non-discretionary. Broker crossing systems and interdealer broker systems bringing together third-party interests and orders by way of voice and/or hybrid voice/electronic execution would qualify as organized trading facilities.

Under the proposals, all trading in derivatives eligible for central clearing and sufficiently liquid would be required to move either to regulated markets, Multilateral Trading Facilities (MTFs) or to the newly recognized organised trading facilities.<sup>22</sup>

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<sup>22</sup> A Multilateral Trading Facility is a system that brings together multiple parties, institutional and/or retail that are interested in buying and selling financial instruments and enables them to do so. These systems can be crossing networks or matching engines that are operated by an investment firm or a market operator. Instruments may include shares, bonds and derivatives.

## V. Recommendations

SEFs may play a positive role in the OTC derivatives market. They may strengthen the infrastructure of the market, help prevent insider trading and other market abuse as well as increase transparency and access to markets for smaller participants. Consistent with the provisions of DFA and with the principles listed in Section II above we recommend that:

- Rules should be flexible enough to allow business models to evolve over time;
- Participants in SEFs should not be constrained by an excessively rigid market structure;
- Products required to be traded in SEFs should be limited to liquid, mature products;
- Rules should not be simply imported from other non-analogous markets (futures, for example) but should take into account the nature of the derivative products traded and the relative sophistication of the market participants;
- Rules need to balance the rights and interests of the party attempting to execute a trade with broader transparency requirements;
- SEFs should not be burdened with the implementation and operation of complex supervisory functions such as monitoring the size of members' positions;
- "Available to Trade" determination should be made by regulators, not by the SEFs;
- Postings to any centralized price screens should be voluntary;
- Regulators should not mandate a specific trading method (Central Limit Order Book for example) for any product;
- SEFs should have discretion in developing their own trading structures;
- Regulators should not impose rules on the potential interaction between different execution platforms that may be offered by a SEF;
- The requirement that an RFQ must go to no less than five market participants might not be in the best interests of those initiating trades and should be dropped;
- The CFTC's fifteen second show rule does not bring incremental benefit to trade execution and should be scrapped;
- Reasonable exemptions should be made for the execution of "block" trades. Rules governing block trades should have each SEF determine whether a trade is a block trade or not. The SEF is best placed to review the swap and the block trade requirements and to make a determination about a block trade;
- Customers should be able to choose whether and to what extent they interact with resting orders on the SEF;
- The CFTC, SEC, and foreign regulators should cooperate and harmonize their approaches; and
- SEFs should be gradually phased-in given the need for the market to build the requisite infrastructure to connect to SEFs and for SEFs to connect to clearinghouses and swap data repositories.

We believe the implementation of these recommendations will be very helpful in addressing some of the weaknesses in the current market while preserving its strengths.