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The CFTC Killed SEF Trading (for now)

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Last week was a busy week in SEF land. November 1 brought in to play a host of new rules, the MAT wars heat up and the Commission made the void rule even more confusing than it was car-flying-off-cliffbefore. So where has that left us? With a huge drop in SEF volumes and a bunch of new questions.

Volumes? What Volumes?

First the volumes.

Much of the no-action put in place before October 2 is now expired. The biggest rules that brings into force are SEF documentation requirements and pre-trade credit checks. The no-action in early October was because no one was ready, and from what we're hearing the situation is only slightly improved. The added confusion surrounding the void rule no-action didn't help the situation either. There is some pretty compelling quantitative evidence this time around (volumes before the October 2 deadline weren't reported) that what little SEF trading existed to date was wiped out by the rules coming into effect. On October 31, SEFs reported roughly $11.6 billion CDS traded. On November 1, with the no-action lifted and the rules in place, that volume dropped to roughly $2.2 billion. I'm as skeptical as anyone about currently reported SEF volumes, **but an 80% drop in volume within 24 hours** is pretty hard to ignore (even if it was in part because half the swap traders on the street were out late partying for Halloween the night before). This is not correlation. This is causation. Our predictions unfortunately came true.

But to be fair (as I always try to be), this is only temporary. The Street simply does not have all of the needed documentation in place with SEFs and clients, and the pre-trade credit checking infrastructure just isn't ready. The documentation concern will be solved with a combination of (lawyer's) time and sponsored access. The lawyer part requires no explanation. Sponsored access, although not a totally new concept for swaps trading, got some attention last from an article in the Financial Times. The idea is that rather than signing documents with every single SEF on which a buy side investors intends to trade, the buy side client can work with an agency broker to gain SEF access via that broker's legal documents and technical connectivity hence bypassing the painful rulebook signing process. Said somewhat more succinctly in the FT article:

"Some investors would rather not have to sign up with numerous Sefs, and prefer to go through a broker-dealer," says Kevin McPartland at Greenwich Associates.

As for pre-trade credit checking, despite the technical readiness of Traiana and Markit, the rest of the ecosystem isn't connected nor prepared to begin sending and receiving limits. I don't have enough space on this page or time this morning to explain just how complex the pre-trading credit checking mechanism will be to get in place, but it is no small feet. Friday (November 1) brought more proof that things weren't ready, with one SEF confirming numerous errors and rejects due to credit checking concerns. The issue isn't so much one of technology – the technology certainly exists – but one of coordination (which the industry is only sort of good at). Time will fix these issues, but the CFTC will need to use both carrots and sticks to get the needed infrastructure in place ahead of the expected Q1 2014 trading mandates.

MAT Wars

The MAT wars also continued last week, with three different press releases furthering the discussion along. Tradeweb (quickly followed by MarketAxess) got the ball rolling for mandatory CDS trading. These MAT applications make complete sense (on-the-run and one previous CDX and iTraxx) and I doubt they'll see much resistance from the market or the CFTC.

On the rates side, Javelin refiled its application with a slightly – and I emphasize ***slightly*** - more narrow list of contracts. IRS over 30 years are no longer part of the application, for example. While this is somewhat of a retreat, likely due to buy side backlash, I'm not sure it changes much. When was the last time you traded a 40 year IRS? As a result of the refile the Javelin comment period has restarted. That means the trueEX MAT application is now first in line to receive CFTC approval and effectively kick-off mandator SEF trading. As discussed in an earlier post, trueEX's application sticks to the most liquid points on the curve. Greenwich conversations with market participants tell us the industry groups and big buy and sell side guys are on board with this approach. And given Tradeweb's IRS application is quite similar to trueEx's, and Tradeweb is largely supported and used by the aforementioned big guys, its pretty clear where there support lies…and you already know my opinion.

Another interesting point to note: industry perception is that the CFTC will approve any MAT applications that cross their desk **unless** enough angry comment letters come in from the buy side to convince them otherwise. What does this all tell us? That the CFTC should have just made the SEF mandatory trading determination themselves just as they did for clearing. But that ship has sailed.

(I was also going to comment in this post about the FX no-action from late last week – but I'll come back to that point in a few days.)

I'll be attending and speaking at the FIA Expo in Chicago this week. Industry folks like to make announcements during this event, so watch for both the CFTC and SEFs to say something interesting (and hopefully youtube videos of CFTC Commissioners getting their dance on).

As always, cheers and jeers welcome.

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