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The Void Rule No-Action makes No-Sense

October 30, 2013

OK, so not all of it. On Friday at 5:55pm (which I guess is better than 11:59pm on October 31) the CFTC issues somewhat expected [no-action relief for parts of the SEF rules] set to take effect on Friday November 1. It focuses on the so-called Void Rule (discussed in an earlier post), and states that trades can in fact be resubmit for trading if they were previously rejected – but only if the reject was not due to a credit issue. That but however is not the only but. In fact the bulk of the no-action document outlines all of the rules the voidmarket must follow if they would like to resubmit trades.

In the interest of time (both mine for writing this, and yours for reading this) I'm only going to focus on the one point that I think makes the least sense.

1. Both clearing members must agree to submit the new trade.
2. Each clearing member must obtain the consent of its customer, if any, to submit the new trade.
3. Neither a clearing member nor a SEF may require a customer to agree in advance to consent to the submission of the new trade. The consent must be sought on a case-by-case basis, after the trade has been rejected.

Let's think about this one. A trade gets rejected because some of the mapping data at the FCM was wrong for the fund in question. Let's say it takes about 45 seconds for the reject message to get back to the SEF (remember, the SEF is not responsible for rejecting trades and doesn't have to do so after 10 seconds, that's the FCM/CCP's job). Within the 45 seconds Bernanke decides its time to start tapering and rates go through the roof.

To point 1 above, both clearing members agree to resubmit the trade because clearing members have every incentive to ensure the trades of their customers ultimately get cleared. Per point 2, both of those clearing members then need to go back to their customers and get consent to resubmit the trade. Maybe not a big deal in normal times, but remember the Fed just started tapering. So now you have one trader way in the money and another way out of the money. Which one of the two do you think will decline the request to resubmit the trade? Exactly.

Then per point 3 – SEFs can't automate this process but putting a line in the rule book that stipulates all rejected trades are automatically resubmit for errors other than credit limit breaches. So there's no way to eliminate the above situation by taking human decision out of the equation. This also means SEFs all need to built functionality to allow clearing members and clients to review and resubmit any rejected trades (the rules say they have 30 minutes to complete the resubmission).

I've heard the argument that once we have pre-trade credit checks in place trades should almost never get rejected. This is true – but only for trades getting rejected for credit reasons. Human error in the client onboarding process will always exist, for example, and so we will always have trades occasionally rejected for non-credit reasons. One other interesting point – the counterparties to the trade only get one shot to resubmit, after that the trade is "void ab initio".

So while I applaud the CFTC for providing much needed clarity on the Void Rule (the other 9 points look good) – looks like there is still more guidance needed.

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