

Lessons learnt

The CDS industry is being asked to undergo a significant transformation in a short timeframe, the likes of which have taken many years in other sectors. While operational challenges and regulatory uncertainties remain, the CDS market's response to enforced reform may serve as a blueprint for other markets in the future. **Anna Carlisle** reports

Almost a year has passed since the Dodd-Frank Act was signed into law, mandating the clearing of eligible CDS contracts through central counterparties (CCPs), the trading of CDS on swap execution facilities (SEFs) and compulsory reporting requirements. In each of these cases, the market has responded positively: numerous firms have spent the past year developing SEF propositions, increasing volumes of contracts are being cleared by CCPs and technology is being implemented to satisfy reporting obligations.

But a common thread in the post-Dodd-Frank era is lack of clarity. Disparities still exist surrounding the definition of SEFs; it is unclear which CDS contracts should ultimately be clearable and with what margins; and questions remain over the timeliness and form in which raw data should be reported.

"One of the challenges facing the market is trying to get clarity from the various regulators on both side of the Atlantic," says Jeff Kushner, ceo of BlueMountain Europe. "This is an extremely complicated matter. It's not what we thought it was when we first went down this road."

However, according to Scott Fitzpatrick, global head of sales at GFI group, the CDS market's response to Dodd-Frank reforms may give some indication as to how other markets will respond to enforced change. "The CDS market could be seen as the poster child for how things will go in other markets, in that the liquid end of the market will be centrally cleared and there will be a strong relationship between electronic platforms for the liquid side of the market and voice/hybrid platforms for the less liquid side," he says. "It also shows that it does take time to set up a complete 'straight through' infrastructure, from an electronic trade to immediate clearing."

More importantly, Fitzpatrick highlights that only a few new entrants have emerged since the CDS market was forced to go cleared two years ago. "There's been no rise of the 'new' e-platform: it's been the incumbent providers of intermediation services that have upped their game, built the infrastructure

and offered stronger services. My personal opinion is that this not a coincidence. I'd expect to see the same in the FX markets and in the interest rate markets. I think it's a very good example of how things will go in other areas."

Ready for launch

SEFs – as defined by Dodd-Frank reforms – are 'facilities, trading systems or platforms that allow multiple participants to trade swaps by accepting bids and offers from other participants, with the process open to multiple participants in the facility or system'. It is also anticipated that SEFs will ultimately provide pre- and post-trade transparency and facilitate a complete record of trades.

However, the CFTC and the SEC – charged with regulating the platforms – are yet to agree on a standardised approach to how the platforms will operate. One such disparity relates to request for quote (RFQ) provisions. For example, the CFTC currently suggests that RFQ participants must request quotes from at least five other market participants, whereas the SEC says participants may send RFQs to as few as one provider.

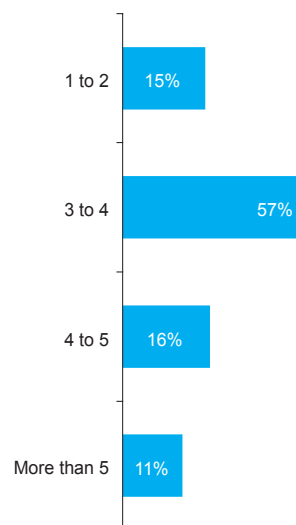
Nevertheless, a large number of SEFs are being geared up for launch. So far, entities planning to apply for SEF status include BGC Partners, Bloomberg, Creditex, CME, GFI, ICAP, Javelin Capital Markets,



Scott Fitzpatrick, GFI Group

Sample TABB Group survey responses*

What is the ideal number of SEFs per asset class?

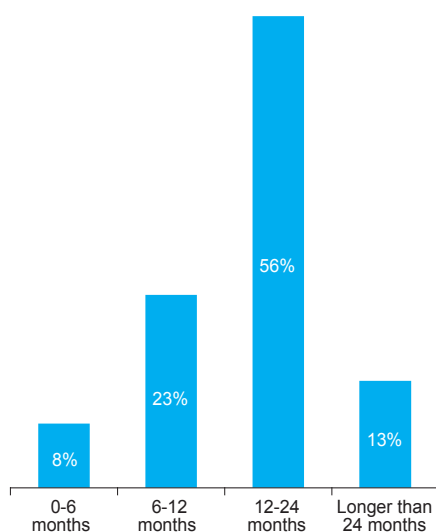


Percentage of respondents to the TABB Group survey

Source: TABB Group

* Results are based on answers from 140 respondents

Following implementation of the SEF rules, how long will it take before SEFs begin to consolidate?



MarketAxess, MarkitServ, Odex, Phoenix Partners, Tradeweb, Tradition and Tullett Prebon – with several other platforms currently under construction.

“We estimate there will be around 40 SEFs, with a minimum of five to 10 SEFs per asset class,” says Jamie Cawley, coo of Javelin Capital Markets. “Time will tell if the market needs that many.”

Indeed, the majority of respondents to a recent survey carried out by TABB Group indicated that SEF consolidation will take place within two years of regulation implementation, ultimately leaving 3-4 SEFs per asset class (*see charts*). However, which of those SEFs gain market share remains to be seen.

Platforms with support from the larger dealer banks and larger buy-side firms that can bring flow and liquidity will most likely have the advantage. But, according to John Wilson, former head of OTC clearing at RBS, the SEFs do not have a

lot of currency to entice potential liquidity providers because of regulatory impediments.

“At the same time, the banks will want to link to a number of SEFs not only because they will enjoy the opportunity to arbitrage between them, but also because they don’t know who the winner is going to be and they all want to be positioned to be able to take advantage of where flow goes,” he says. Consequently, there will be a considerable cost for each to link to a SEF.



Jeff Kushner, BlueMountain Europe

Fitzpatrick expects to see a proliferation of firms wanting to be SEFs, but says the general feeling is that major dealers will look to link up to incumbent businesses. “It’s one thing to build an electronic trading platform, but when it comes to running an efficient market 24/7 – that’s a whole different ball game,” he says. “Why introduce more risk into a business that’s already undergoing massive change?”

Unrealistic demands

Proposed legislation requires that all trades on SEFs should be executed electronically – a requirement that is deemed unrealistic by market participants, who suggest a hybrid model of electronic broking and voice broking may be more realistic, particularly for size discovery. For example, in a typical trading environment at present, the liquid end of the market (such as credit indices) tends to trade on the screen-based format without intervention from a voice broker, but for less liquid names a combination of electronic and voice trading are required.

“In OTC markets, I believe the hybrid model will prevail,” says Fitzpatrick. “That is, you’ll have the electronic model for the liquid end of the scale and voice intermediation for the less liquid names, which a pure electronic SEF just can’t provide.”

The exception to the electronic trading rule are block trades, which – according to current CFTC proposals – are a notional or principal amount that is greater than 95% of transaction sizes in a category of swap instrument during the period of time represented by the distribution of the notional or principal transaction amount. When asked about the sizing of block trades, 22% of respondents in the TABB survey said the size is too big, 22% said it is too small and, interestingly, over 40% of respondents suggested that block trade requirements are nothing but a loophole that allows participants to limit market transparency.

Trade transparency is another area of uncertainty. US regulators require trade details to be published within several minutes and block trades must be published within 15 minutes. It has been suggested that these requirements could hinder liquidity because the speed at which pre- and post-trade reporting is anticipated would advertise to competitors that a firm has an unhedged position and others will be able to take advantage of that.

“Basically you’re saying to the world: ‘I’ve just done an enormous trade; come and hit me’”

"As currently proposed, the block trading requirements will have a delay of 15 minutes for a very small number of very large trades. It will be physically impossible to hedge such trades in such a short timeframe," says Wilson. "Basically you're saying to the world: 'I've just done an enormous trade; come and hit me'."

Kushner agrees: "Pre-trade and post-trade discovery will prove very challenging. The regulators need to know in understandable terms who is doing what. The question is: do they need to know before the trade and in what form?" he asks.

Kushner adds: "Raw data is raw data and without some sort of understanding of why it exists in that form it will be fairly easy to withdraw incorrect conclusions."

Margin requirements

It is nearly two years since the first batch of index CDS were centrally cleared. Since then, momentum has been gathering as end-users look to engage with clearing members and clearing members ready themselves for the task ahead. The majority of credit indices are now clearable and some of the single name contracts that constitute the main indices are also being cleared.

The infrastructure and technology is in place for T+1 or T+0 processing. ICE, for example, has recently launched the Affirmed=Cleared (A=C) interdealer workflow on its ICE Link platform, which enables same-day clearing of CDS trades, in line with the Dodd-Frank Act in the US and the EMIR initiative in Europe.

The introduction of A=C enables a trade to be cleared within minutes of execution. Trades are immediately submitted for clearing following affirmation on the ICE Link platform and, once cleared, all parties are notified in real time on ICE Link. Prior to the introduction of A=C, interdealer CDS transactions were sourced from the DTCC Trade Information Warehouse (TIW) and cleared on a weekly basis.

"Trading-wise, we have seen a tangible transition towards the cleared side of the market, especially indices," notes Fitzpatrick. "In single name CDS there's been an increase in trading volume in cleared names, so I'd say the industry has reacted the way in which the regulators hoped that it would."

But ambiguity as to which contracts will ultimately be clearable remains. Liquidity, market experts say, will be key in determining which single names will be eligible, as clearing-houses need to manage margins.

Without liquidity, margins cannot be determined. At the same time, however, a name that is liquid today may not be liquid in six months' time.



John Wilson, formerly at RBS

Andre Cappon, president at the CBM Group, says that the idea of forcing the entire CDS market onto clearing-houses is a bit of an illusion as there will be so much that is too tough to handle. "I don't see a problem with index names or well-traded single-name CDS, but outside those it will be very difficult," he says. "The legislators are politicians and don't think about technical issues of the financial market. It's a very sticky technical issue."

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OTFs versus SEFs

Although European and US regulators have G20 requirements on OTC trading as common ground, the two regions appear to have taken differing approaches to regulating trading venues. Unlike the stringent requirements in the US mandating that SEFs must operate on a purely electronic basis, the European equivalent – organised trading facilities (OTFs) – appear to embody the hybrid environment in which many firms currently operate; in other words, a combination of voice and electronic trading.

The European Commission's consultation paper on the review of the Markets in Financial Instruments Directive (MiFID) gives an example of an OTF as 'a broker crossing systems and interdealer broker systems bringing together third-party interests and orders by way of voice and/or hybrid voice/electronic execution'. However, one issue that banks are concerned about in Europe is whether a single-dealer platform would qualify as an OTF.

It is understood that – as in the US with the CFTC and the SEC requirements – any execution venue must provide multilateral access. Participants assume that regulations regarding this matter will mirror that of the US, although the text is currently ambiguous.

In the meantime, banks and brokers are trying to work out what has to be done in order to qualify or register as a SEF or OTF. In Europe, it is assumed that institutions will qualify as default as an OTF, but in the US it is less clear.

Questions regarding the level at which a firm must register as a SEF are unclear; for example, does a bank qualify as a SEF or does a particular business area of a bank register? Or does a bank or broker register as a SEF and then implement rules relative to different products?

OTFs are still a concept, however, and it remains to be seen whether the final draft of the MiFID documentation will include these trading venues as well as the pre-existing trading venues such as MTFs.

Antitrust implications

The European Commission launched two antitrust investigations into the CDS market in May (see *SCI* 3 May), the first of which examines whether 16 banks and Markit have colluded and/or may hold and abuse a dominant position in order to control the financial information on CDS. The second case is investigating whether the preferential tariffs granted by ICE Clear Europe to nine of these banks have the effect of locking them in the ICE system to the detriment of competitors.

The EC says it is opening these cases to improve market transparency and fairness in the CDS market. "Lack of transparency in markets can lead to abusive behaviour and facilitate violations of competition rules and the Commission should react accordingly. I hope our investigation will contribute to a better functioning of financial markets and, therefore, to a more sustainable recovery," Joaquín Almunia, Commission vp in charge of competition policy, explained at the time.

The probe itself does not appear to have had an immediate impact on the industry as a whole, although some accuse the regulators of hypocrisy: on the one hand demanding that CDS be cleared, only to penalise those that have made this happen. It is also understood that the main

dealers are working with other clearinghouses (Eurex, LCH, Clearnet and CME) in the CDS space, with LCH now having most of the dealers signed up and ready to go.

"Unfortunately, clearing of CDS and other instruments is not naturally geared to having lots of clearinghouses," says John Wilson, former head of OTC clearing at RBS. "People get the maximum benefit from clearinghouses when everyone uses the same one."

He adds: "I think it's also wrong to suggest that there isn't competition. It's just that people chose to use ICE as opposed to using Eurex or CME."

Wilson suggests that the European antitrust probe may deter banks from getting together and trying to move the market forward collectively in the future; for example, by getting more CCPs up and running. "It will cause people to have pause for thought because if you get together to do that, while you are generating more competition by creating more clearinghouses, conversely your support for them and collaboration with other banks on that may be seen as having antitrust implications. It could well act as a break on the emergence of additional competition in clearing as opposed to stimulating it."

At some point, Cappon believes that regulators will admit that not every CDS can be cleared and let those names be dealt with by the sell-side. "I don't see any other solution – this is the reality. It's very commendable that CDS should be put through clearinghouses and exchanges – it will add transparency and reduce counterparty credit risk. However, what remains unclear and unresolved is how much margin is needed when names are illiquid or when things turn really sour."

Wilson adds: "If clearinghouses were forced to clear names that they were uncomfortable with, then I think we'd move into very dangerous territory."

Cawley suggests that right now he would expect clearinghouses to offer services for index and index-constituent names. The next step would be to offer various sets, either by sector or by liquidity baskets, with names on which curves can be taken and properly priced and managed on a risk basis.

"They can then start to scale in various groups and increasingly more names into their books for clearing. Does that mean we ever get to the last name on the book? Probably not," Cawley says.

"If clearinghouses were forced to clear names that they were uncomfortable with, then I think we'd move into very dangerous territory"

Those contracts, he indicates, will probably become less liquid and will trade by appointment. "They will be more difficult to trade from a capital adequacy point of view, so it's argued that some won't trade at all with a culling of certain names," he says.

Numerous challenges remain, therefore – not least for the investment banks and corporate counterparties that have not had to post margins in the past. According to Kushner, this poses a whole host of challenges – ranging from technological to how the capital is managed – and questions as to whether there will be a drag on returns based on the fact that they actually have to have money to post.

"Buy-side firms like us have always operated in a variation and additional margin world, so changes brought about by the regulatory overhaul haven't been that great," says Kushner. "We've always been asked to post margins on our trades. Dating back to 2005, we have operated in a central clearing-like environment, where we gave the majority of our trades to one particular prime broker and were margined on all of the trades."

Staggered enforcement

It has become clear that the one-year timeline stipulated by the Dodd-Frank Title VII requirements, establishing a framework for regulating OTC derivatives, is unlikely to be met and both the SEC and the CFTC have now announced they will stagger the implementation or enforcement of rules over the coming months as they finalise the rule-making process to implement the Act. They have also granted temporary relief to market participants from compliance with certain of these requirements that would otherwise apply on 16 July.

Industry participants have commended the commissions' decision to scale in the various rule sets, deeming it a more practical approach, given that the process is taking longer than anticipated. "Temporarily and to the extent appropriate, our goal is to preserve the pre-Dodd-Frank Act legal framework until we complete the rulemaking tasks and develop a workable implementation plan," says Robert Cook, director of the SEC's trading and markets division. [SCI](#)