Crisil Coalition Greenwich

Impartial Access: The CFTC Isn't Messing Around This Time

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The CFTC issued a slew of new guidance and rules last week, two of them particularly interesting and impactful. First was the rule that requires clearinghouses to have credit facilities available to back up all margin posted in US Treasuries. I (and pretty much every one else in the market) think this is ridiculous. If US Treasury prices are moving so quickly that a one day liquidation period creates trouble, the value of the US dollar (what the Treasuries would be converted too) would be equally as volatile. These are risks clearinghouses, clearing members and clients are fully aware of and have accounted for. Does this mean the CFTC doesn't trust the debt of the US government? I'm acutely aware of the importance of customer protection, but this is forcing customers to buy insurance that they don't want. Although in some cases, so is clearing. Moving on…

The much more interesting text out of the CFTC last week came in the form of guidance regarding fair access to SEFs. The full text is here. They basically call out and condemn a number of current SEF and major dealer practices (without naming any names), and were refreshingly to the point. Those practices include:

- Requiring customers to sign breakage agreements is not allowed
- SEFs can't designate members as liquidity takers OR makers – all can do both
- SEFs can't require members to be self-clearing
- SEFs can not restrict the number of firms someone can RFQ out to – all must be an option

If you're a student of SEFs you can probably figure out exactly who caused the CFTC to say what (and if you're not, Chairman Gensler spelled it out at SEFCON in NY). Regardless, this is actually a pretty big deal and removes much of the freedom we believed SEFs to have in setting their own rules. In one of my recent Greenwich Reports, I give the CFTC credit for creating a flexible system:

Regulators wrote new SEF rules in a way that will encourage the birth of markets that can serve fixed- income investors with varying levels of activity. Under the rules, SEFs must provide fair access, but not necessarily access for all. Some SEFs will, for instance, welcome only registered swap dealers as trading participants—a perfectly acceptable criterion under CFTC rules given it is transparent and applied equally to all. Such a SEF would attract mostly large notional interdealer trading.

Conversely, other SEFs will create a marketplace that encourages emerging dealers to provide liquidity in a form useful to asset managers and hedge funds with lower fixed-income volumes. Simplified counterparty credit exposure via central clearing and anonymous trading produces a more palatable market for non-traditional liquidity providers. So while the most active fixed-income asset managers can continue to access liquidity from the largest dealers on some SEFs, the market's remaining supply and demand will become more *transparent and accessible to those who need it via competing platforms. Although such a market is bifurcated, it will help liquidity rather than hurt it.*

A good number of the freedoms I mention above are now gone. SEFs can decide whether to offer name give-up or anonymous trading, and arguably can set minimum trade sizes, but that's about the extent of "reasonable discretion" they're allowed. Pools of liquidity will still grow based on trading styles and business models, but it will now be up to market participants to decide how these pools form rather than the SEFs.

Many of the 18 registered SEFs have a lot of work to do – some more than others. Technology needs to be updated, permissions amended, rule books need to change and market participants need relearn how the market works. New entrants like Tera, Javelin and TrueEX are fine (and in many ways just had their models validated), as this has been their long standing approach. Interdealer brokers will be impacted the most, having their potential client base in some markets grow from a few dozen to a few hundred (which could be a huge lift for some). This generally is good news. The guidance makes it a little easier to explain to their core customers why they have to open up the gates (although not a free pass, given the majority of their business is still in non-SEF products). Most if not all of the big guys were going this direction anyway; the timeline has just been accelerated. Now rather than a few SEF segments (IDB, D2C, C2C) we will have one. Not only can everyone now trade with everyone, but every SEF also is competing with every SEF.

The next question is do non-dealer buy side firms want to trade in market formerly known as inter-dealer (like attending a party because your mom called your friends mom and said they need to invite you)? The short answer is yes. Adjusted for trade size, there still exists a spread between the prices in the interdealer market as compared to the prices in the dealer-to-client market. The more sophisticated clients, and soon many other clients, will want to recapture that spread. Over the long term this could have a positive impact on alpha and a negative impact on G14 swaps trading revenue, just as the competition brought on by the 76 other registered swap dealers will.

The bottom line: I don't like explicit rules that cut into free market competition between SEFs, but I do like an accelerated move to many-to-many trading and a model much closer to the best-man-wins. The commission has been accelerating what would have been an organic evolution since 2010, and this guidance is no difference. This is American capitalism at its best.

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