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SEFs and OTC Trading
Special Report

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Much Ado About SEFs

Love them or hate them, swap execution facilities (SEFs) are here to stay. Although the "Big Bang"—predicted to transpire in February, when certain instruments had to be executed electronically—never really happened, derivatives trading reform has had a profound impact on technology, market structure, and the international conversations about finance. Indeed, the establishment of SEFs is just the first stage of this change, with Europe now beginning to work on its own version of electronic execution in the form of organized trading facilities (OTFs), and some parts of Asia-Pacific beginning to consider the future of the market in light of mandates from the Group of 20 nations.

The build-up to SEFs and their birth hasn't been easy and the range of opinions on their practicality and usefulness is still diverse among participants. Privately, some senior figures in fixed-income trading say they see SEFs as simply reporting by another name, while others say the fight to make regulators understand that not everything can trade like equities has been exhausting, with victories measured in small concessions and footnotes.

Ultimately, swaps reform isn't about placing burdens on dealers through reporting mandates, centralized clearing, or saying that Bank X may no longer trade directly with Bank Y for no reason. Just as markets have evolved and continue to do so, the ways in which those markets are overseen have to keep pace. The reduction of systemic risk is the main objective—some might say the only objective—and bringing an opaque, bilateral, primarily voice-based market into the modern age is the only way to do that. It has not been a perfect ride by any means, if the amount of incorrect reporting and failures on the part of regulators to even understand the data is anything to go by.

Small problems continue to plague SEFs, as Michael O'Brien, director of global trading at Eaton Vance, states in this report's roundtable. While Eaton Vance is doing everything in line with SEF trading, he explains, it still has problems with the rulebooks that haven't been resolved, and therefore doesn't trade directly just yet. Curiously archaic rules also remain, such as the obligation to store and retain physical contracts, rather than digital copies.

But signs of acceptance are filtering through, with increased SEF volumes and data suggesting that dealer-to-client flows are increasing, even matching dealer-to-dealer numbers on the larger SEFs in recent weeks. Inevitably, the market will assert itself over time, most likely in the form of a rationalization of SEFs to a more manageable, streamlined number. ■

James Rundle
Deputy Editor, Sell Side

UBS Executes First Interest-Rate Swap as Introducing Broker

UBS Investment Bank has completed its first trade as an introducing broker on behalf of a client via UBS Neo, the bank's global distribution and execution services platform. UBS says the order was communicated to the Neo platform and automatically routed to the TrueEx swap execution facility (SEF), before being executed anonymously in accordance with the central limit order book (CLOB) model.

UBS was responsible for the pre-trade credit check as the "standby clearer," while the order was executed and cleared by the Chicago Mercantile Exchange (CME).

"Our goal is to help our clients navigate this rapidly changing market landscape and we believe the introducing broker model is the most efficient and effective way for clients to access the regulated SEF markets," says Paul Hamill, global head of fixed-income agency execution. "This model provides our clients access to liquidity across all the SEFs, without the complex technological, legal and operational requirements associated with direct membership or sponsored-access models. We are very excited to have executed the first client CLOB trade using this model for our client."

> "We believe the introducing broker model is the most efficient and effective way for clients to access the regulated SEF markets." **Paul Hamill, UBS**

Buy Siders: We'll Connect to Five or Six SEFs

If the two buy-side representatives from a Tabb Group conference panel are considered a reliable reflection of the greater buy-side community, then it appears that investment managers are not interested in connecting to all 22 SEFs currently operating in the US market. Speakers from Babson Capital Management and Vanguard Group said they had significantly narrowed down the list of SEFs their companies would be trading on.

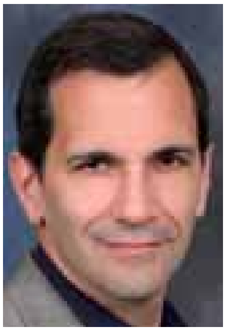
Babson has five or six preferred SEFs, while Vanguard has chosen three for trading rates and two others for credit. Vanguard's Sam Priyadarshi, head of fixed-income derivatives, said the decision stemmed from a desire to stay ahead of the trading mandate. Winnowing down the final list allows his firm to jump-start the onboarding process with the chosen five

"There are a lot of operational issues: connectivity to the order management system, straight-through processing, credit checks with credit hubs, connectivity with futures commission merchants (FCMs), connectivity with swap data repositories (SDRs) as well as the central counterparties," Priyadarshi explained. "There are also issues around the trade workflow and trade protocol: Should we trade RFQ+2, RFQ+3, should we do request-for-stream—where do we get best execution?"

As OTC Marketplace Evolves, More SEFs May Rise

Barry Smith, director of global exchanges and trading venues at Equinix, believes that in 2014, there could be a consolidation of the more than 20 swap execution facilities (SEFs) currently operating in the US market. But even though many presume there will be fewer SEFs in the future, Smith says people shouldn't be so quick to assume that consolidation is the end state.

"I've heard people say that we're not going to see that many SEFs in a few years," he says. "Well, if you look at the equity space and dark pools, there are now about 50 in the US. As the SEF marketplace forms, some of the 22 will be acquired and some will fold, but I really don't think we'll see the maturity of this market for about five or six years. People say that if a SEF doesn't have liquidity it will fail; well, when Liquidnet came in they didn't have any liquidity and the next thing you know they're launching peer-to-peer, buy-side–to–buy-side blocks."



> "Some of the 22 SEFs will be acquired and some will fold, but I really don't think we'll see the maturity of this market for about five or six years." **Barry Smith, Equinix**

Regulatory changes that were finalized last year by the Commodity Futures Trading Commission (CFTC) are driving technology spending this year, according to Smith. "That shift, for some people, is causing a lot of uncertainty, while others are starting to see the opportunity," he says.

Flexible Access to Derivatives Liquidity Eases Shift to SEFs

Several years after the passage of the Dodd–Frank Act, the derivatives industry in the US has begun its transition to trading swaps on regulated markets called swap execution facilities, or SEFs. And, as Tradeweb's Billy Hult explains, the marketplace is evolving at a rapid pace, and investors are hard at work to overcome the challenges of building and tuning their operational infrastructure to access liquid markets.

Though electronic trading of derivatives is not entirely new to the institutional financial community, new rules and reform from the US Commodity Futures Trading Commission that outline the trading, clearing and reporting of these swap transactions has required a significant increase in the development of technology to execute and process all of this trade information. Due in part to the design of a phased rule implementation, we've seen these challenges realized in the slow but gradual increase in trading volumes on SEFs, and only for a subset of interest-rate and credit derivatives so far.

> "Agency access in newly regulated derivatives markets gives customers greater choice in the ways they access liquidity in a compliant, efficient workflow. It allows them to continue adapting their technology to meet the new regulatory requirements as they begin to adopt SEF trading for a broader portion of their derivatives business.

Positive Steps

These are positive steps toward a more transparent and efficient global derivatives market. A range of customers are engaging on SEFs, but many of the real money institutions and asset managers have yet to move the majority of their derivatives trading onto SEFs. Other customers have yet to trade or become members of SEFs. Factors influencing this decision include cost, the operational lift, and the ability to trade outside mandated swaps for SEF trading and more.

Marketplaces like Tradeweb offer customers direct connectivity to its SEF so they may trade using the graphical user interface (GUI), which we call the Tradeweb Viewer. The software serves as a portal to a greater distribution of counterparties in a fast, secure, and compliant environment to execute derivatives trades.

For traders who transact fairly often, this kind of set-up makes sense. It brings a broad scope of liquid swaps onto one dashboard with different tools and functionality to enhance their trading experience. One great example of this is the ability to check for available credit with a clearing broker or futures commission merchant (FCM) to complete a clearable swap transaction in less than a second.

Other customers, however, may be seeking access to liquidity on SEFs through an intermediary, instead of becoming members of a SEF themselves. Market operators have responded to customer interest in agency-style trading, introducing new functionality in February of 2014 to support three different types of access to the SEF via an FCM.

On Tradeweb, the first mode of agency trading is called direct market access (DMA). It allows an FCM to support clients' ability to access the SEF GUI, and all of the transactions are processed via the client's FCM for clearing. Customers can also use their FCM to execute trades on their behalf using functionality called "On Behalf Of" (OBO) trading. In an OBO swap transaction, an introducing agent executes trades directly on a SEF on behalf of their clients using the TW SEF interface (GUI). The customer is disclosed to counterparties, and the introducing agent expresses the client's instructions in all of the interaction on the SEF.

Another Approach

Both of these agency models for SEF trading are supported on SEFs today, but there is another approach that is also coming to market via independent software vendors (ISVs). In this model, customers gain indirect access to a SEF through an embedded SEF GUI or front-end portal provided by the ISV and/or introducing agent. Agency access in newly regulated derivatives markets gives customers greater choice in the ways they access liquidity in a compliant, efficient workflow. It allows them to continue adapting their technology to meet the new regulatory requirements as they begin to adopt SEF trading for a broader portion of their derivatives business.

Despite the choices available for agency trading, it has yet to take off in a significant way since the certification of swaps as "Made Available to Trade."

It is still very early to forecast how the majority of market participants will interact on SEFs, but it is important that market operators provide robust, flexible trading infrastructure to support the most diverse means of trading swaps within the new regulatory regime. The industry has met this operational challenge head on, and customers have continued to trade swaps. It's been a huge operational lift, but what remains is how trading behavior will evolve with it. ■

Billy Hult is president of Tradeweb Markets.

Candidates for Consolidation

Swap execution facilities are now an accepted facet of the US trading landscape, allowing market participants to trade swaps electronically, and by so doing, adding transparency and reducing systemic to a previously manually intensive, opaque world. But many questions about such platforms remain unresolved, the most pressing of which is when the anticipated rationalization of their number will begin.

Q Before swap execution facilities (SEFs) came into play last October, the accepted wisdom was that there would be a whittling down of the number of players to a handful per asset class. Are we likely to see a shake-up of the market in the near future, with only a handful of the largest, most successful players surviving?

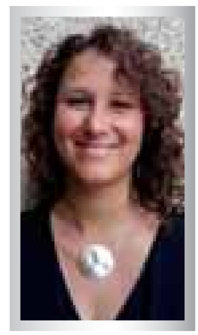
Neil Monaghan, director, North American head of futures and over-the-counter (OTC) post-trade product development, Citi: I don't think it will be a shake-up, but there will be a consolidation to the key SEF or SEFs by asset class and functionality. The real moving point will be how the inter-dealer brokers (IDBs) adapt to the needs of the buy side and conversely if the buy-side SEFs can make inroads to the inter-dealer market. Currently, the market is still split, but if a SEF is able to cross that line, it would create more consolidation.

Michael O'Brien, director of global trading, Eaton Vance: I definitely think that there will be a whittling down. I'd hesitate to put a number on it, but there will be fewer than there are now, and the number depends on whether people choose to be direct participants on SEFs or use an aggregation model.

The reason I say that is because if you choose to be a direct participant, you just can't connect to all of them. From a technology perspective, knowing how to use 24 different systems is just too much—you have to pick a handful. Those that you do pick will likely have an advantage in that they might already be on your desktop, and also there will be those that have liquidity, so there has to be a whittling down in that respect. If people use aggregators like UBS Neo, which can go out and check all of the SEFs so that you don't have that technology and usability issue, then you'll potentially see more than if everyone chooses to be direct participants, but ultimately the number has to come down.

> "In the migration toward regulated trading, manual processes and less-than-secure communication methods such as email will eventually need to be phased out. This will put greater pressure on the buy side to invest in technology in order to tighten up procedures, comply with regulatory obligations on themselves as well as their relationship banks, and achieve full STP trading." **Jodi Burns, Thomson Reuters**

Billy Hult, president, Tradeweb Markets: We are still only a few weeks into SEF trading for a limited range of interest-rate swap and credit default swap instruments that were certified by the Commodity Futures Trading Commission (CFTC) as Made Available to Trade (MAT), so it's still fairly early to forecast how liquidity on these electronic platforms will evolve. Regulators and the industry have been focused on a gradual transition toward trading on SEFs throughout the entire reform process, so one would expect liquidity to follow a similar progression into this new market structure.



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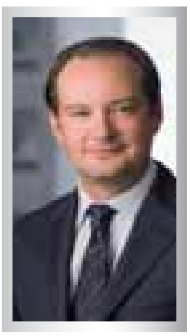
That said, there won't be a sharp shift in where liquidity moves venue-wise, but as more buy-side customers start trading electronically, we'll see leaders emerge between the different asset classes. There will be fewer SEFs than there are today. Customers want a choice in the way they trade these derivatives, and the opportunity to access liquidity in different ways, from a few different places, should be attractive for institutional investors.

Jodi Burns, head of regulation, post-trade networks, Thomson Reuters: We don't believe there will be a shake-up in the near future, as we are still in the early chapters of the SEF story. However, it's highly unlikely that the derivatives markets can indefinitely support the nearly 20 SEF platforms operating today. The winners and losers will be chosen by participants on the basis of liquidity, functionality, and customer service. The focus on liquidity means that incumbent platforms such as Thomson Reuters have a head start over new entrants.

Q To what extent do historical relationships determine which SEFs firms connect to—for example, is an existing client of Bloomberg more likely to connect to Bloomberg's SEF?

O'Brien: If a potential SEF is already on my desktop, and I have real estate devoted to it, I know how to use it, and frankly, I already have a username and password, that is a tremendous advantage. If all SEFs are going to do is have a screen and you'll just execute on that, then you'll naturally go to the one that's there. In order to overcome that, a new SEF has to have some sort of value-add that's not offered by the incumbents.



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Hult: The broader fixed-income and derivatives markets were built on trusted relationships between counterparties hedging and exchanging risk to meet their investing needs. The relationship-oriented nature of these markets also permeates the infrastructure of electronic platforms like SEFs, where participants have invested in technology and personnel to achieve the benefits electronic trading provides.

Established electronic trading platforms for swaps most certainly had an advantage with the institutional community, with much of their technology and mapping already in place ahead of regulatory reform. Obviously, we've all had to make changes to adapt to new rules, but the experience and knowledge of how these products can trade more efficiently and transparently on SEFs helps support a more scalable model for the migration of liquidity to e-trading.

> "In contrast to electronic equities markets, the speed of execution and transaction processing in the swaps industry is considerably slower. However, this is not as much a function of technology as it is about the purpose of derivatives instruments in managing risk and how they trade. Electronic trading of swaps has significantly increased the speed in which customers operate and transact online." **Billy Hult, Tradeweb Markets**

Burns: The existing relationship a market participant has with a platform provider is an important factor when choosing what SEF to connect to. Ultimately, firms will want to trade where they have access to the liquidity and functionality they've come to expect when trading on multilateral platforms. To maintain these relationships it's necessary to continually engage in dialogue with customers.

Monaghan: It is quite important and it really comes down to integration. If a client is integrated with a conduit, they are much more likely to want to use their SEF since they have less to build. Also, if they are trading other products on a platform's screen, using their SEF product is easier. A new SEF that wants to enter the space needs to bring great functionality to unseat an incumbent provider.

Q How far do you see SEFs attempting to differentiate themselves with technology, such as tools along the lines of proprietary execution management systems, pre-trade risk technology, and reporting functionality, or is differentiation along purely liquidity lines?

Hult: Liquidity is paramount in developing an effective marketplace, but the tools and functionality that help enhance and improve that experience in efficient ways are also very valuable. At Tradeweb, we've been hard at work to provide customers with what we consider is the most diverse SEF offering overall.

We have an anonymous central limit order book (CLOB) called DW SEF, and a disclosed, request-based platform called TW SEF, in addition to leading technology in pre-trade credit checks, bunched orders, compression for rates swaps, and voice/block trade processing. All of these elements are designed to help provide a more fluid environment for our customers to be able to continue trading derivatives effectively. It's a mutually linked ecosystem between functionality and liquidity. That doesn't necessarily mean the next "mouse trap" will capture significant liquidity from incumbent markets, but enhancing the trading experience for investors will always drive innovation in electronic trading.

Burns: SEF differentiation will come from all of the above. It is not purely deep liquidity that will differentiate a SEF from its competitors. Thomson Reuters has built a complete end-to-end workflow solution including straight-through processing (STP) and settlement that meets the needs of both buy-side and sell-side firms trading on our SEF. SEFs will also differentiate in how they minimize change in the customer's trading experience in response to regulation. As part of our overall commitment to support regulatory reporting obligations impacting customers who trade foreign exchange (FX) and interest-rate swaps, Thomson Reuters recently developed a standalone trade reporting service that supports trade reporting to the Depository Trust and Clearing Corp. (DTCC) in a number of jurisdictions, including Europe, Hong Kong, Japan, Singapore, and the US, regardless of trading venue or the counterparty to the trade.

O'Brien: Liquidity is one of the biggest driving factors. I should mention that I'm not a direct participant on SEFs yet. I have relationships with all of them, and I've actually done everything to participate on around five of them except for signing the rule-book, because we still have an issue with that, so we're not direct participants yet. But once the CFTC's Rule 1.35 on recording gets clarified then we're likely to move quickly, but we are trading, using an aggregator.

Monaghan: They will use technology, but since a SEF probably will never have a complete view of a client's portfolio, they will probably steer away from the risk and reporting and move more to package and allocation functions to reduce latency and increase liquidity. I could see them looking at smart-order routing and tools for price discovery to help clients get better execution.

Q How important is latency to the new derivatives landscape—not just for execution, but also pre-trade processes such as credit checking, and post-trade processes such as reporting to swap data repositories?

Burns: Low latency is essential to ensuring effective risk management in today's trading environment. Latency is important in several aspects of SEF trading: trading in CLOBs; pre-trade credit checks to increase the certainty of clearing; notifying clearinghouses and clearing brokers of executed trades; and providing trade, reporting, and clearing status back to counterparties.

> "We need to move to harmonization. We're managing both US and European-domiciled funds, so the biggest problem for us would be if trading on a SEF didn't keep us compliant with European rules, or vice versa. So for me, based in the US, if I were to do a trade under CFTC rules, then I need that to be honored by Europe. That's the most important harmonization issue for me."
> **Michael O'Brien, Eaton Vance**

Monaghan: It is the hottest topic right now. Pre-trade checks are a huge focus to ensure latency is imperceptible and every futures commission merchant (FCM) is working with the SEFs and the hubs to ensure this. Post trade is also important—as an FCM, I want the executed trade in the client's account so that I can ensure their risk is whole since there are still off-SEF trades. Everyone in the industry is pushing everyone else for metrics on speed of limit checking, execution, and clearing. I can't speak directly on swap data repository (SDR) reporting.

O'Brien: I think there's going to be a move in the latency-sensitive direction in terms of trading—a lot of these instruments are liquid enough to handle it. If you think of 10-year interest-rate swaps in the US, they're some of the most liquid I can think of. CDX, the credit indices, are all very liquid, and while the high-yield instruments may not be yet, you're certainly going to get an increase in the speed of trading, or high-frequency trading, or whatever you want to call it. That's certainly something where a traditional buy-side firm goes from executing in a bilateral world where that's not really an issue to an electronic world where it is, and trading strategies are going to have to be adapted to that world.

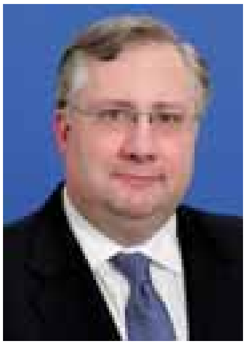
Michael O'Brien
Eaton Vance

Hult: In contrast to the pace of the electronic equities markets, the speed of execution and transaction processing in the swaps industry is considerably slower. However, this is not as much a function of technology as it is about the purpose of derivatives instruments in managing risk and how they trade. Electronic trading of swaps has significantly increased the speed in which customers operate and transact online.

Tradeweb helped pioneer straight-through processing in electronic fixed-income trading, and we've been able to meet all the requirements from regulators in accelerating the speed in which information is transferred throughout the entire trade lifecycle. For example, pinging FCMs for a pre-trade credit check takes less than one second on the Tradeweb TW SEF. Should customer demand lead us toward a faster trading environment in derivatives, we'll adapt and leverage our technology to support our clients' needs.

Q How is technology at buy-side firms being affected by these changes? Are they being forced to upgrade connectivity to SEFs and clearing brokers, for instance?

O'Brien: In the main, we're already connected to the SEFs, as they're already on our desktops and those are the ones we're focused on. So in those terms it hasn't been much of a technology build. I think the biggest technology challenge has been testing the trading in a live environment. You can do all of the testing you want in a user-acceptance world, but when you go to actually do your first trade, there are always unanticipated issues. Are accounts mapped in the correct way? When we click on a platform to do a trade or to set something up, are we seeing what we expect to see? So it wasn't so much a technology build as it was ensuring that in a live environment our technology was set up correctly to handle our trade from a pre-trade credit check all the way through to clearing.



Neil Monaghan
Citi

Monaghan: I don't know if I would say upgrade, as the connections didn't exist before. They are definitely being challenged, as are we all. It represents a new level of reconciliation and shifts the focus of trade checks out to the point of trade since the cleared contract cannot be amended after clearing. This is a main reason for an entity offering a SEF that is already integrated in some way to a client, such as to their order management system (OMS), which has a leg up. Beyond portfolio reconciliation, margin technology is being stressed. The buy side is seeing the need to build or find analytics to verify margin calculations. They have lost the dispute-resolution process with clearing and need to exactly measure the central counterparty (CCP) calculations to ensure calls from the FCMs are correct. Finally, they are being stretched from a risk technology perspective, as they try and capture CCP exposure in their internal risk view.

Hult: There has been a significant operational cost for market operators and participants in adapting to US derivatives reform under Dodd–Frank. In particular, clearing requirements have created a significant increase in the information flow surrounding execution of swap transactions. It's been a challenge for market operators and participants, but providing infrastructure to conduct pre-trade credit checks and also process trade data to FCMs, clearinghouses and SDRs are all issues the industry has solved in the new regulatory environment.

We've continued upgrading our application program interfaces (APIs) and graphical user interface (GUI) to reduce the operational lift for our customers, but innovation and reform has led to greater connectivity and greater workflow across the entire derivatives marketplace. But like many investments in technology, the potential benefits electronic trading can deliver in terms of greater price transparency and trading efficiency are exciting for many clients.

Burns: In the migration toward regulated trading, manual processes and less-than-secure communication methods such as email will eventually need to be phased out. This will put greater pressure on the buy side to invest in technology in order to tighten up procedures, comply with regulatory obligations on themselves as well as their relationship banks, and achieve full STP trading.

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> **Neil Monaghan, Citi**

Q As derivatives reform continues in a global sense, with organized trading facilities (OTFs) being established in Europe over the next few years, do you see global connectivity and networks for derivatives trading becoming a reality, or will technology be delineated on regional lines, for different regulatory jurisdictions with separate requirements?

Hult: Tradeweb already operates two SEFs in the US and a multilateral trading facility (MTF) abroad to support our global network of derivatives customers. Global infrastructure can certainly exist within a broader derivatives marketplace, but it must be built on market infrastructure that ensures compliance for participants trading within it. However, it's difficult to predict where there will be overlap between organized trading facilities, as derivatives reform outside the US is still in flux. The industry is working hard to avoid regulatory arbitrage, while providing the most effective, liquid markets for clients trading swaps. And, as we continue to learn more about how the global regulatory landscape is evolving, we'll adapt to provide global solutions.

Monaghan: I think there will be global platforms, but the devil will be in the detail. The trading facility will have to build and maintain the various trading rules and clearing models. I think it will delineate between countries that have reciprocity versus those that don't.

O'Brien: We need to move—at least when it comes to SEFs—to harmonization. We're managing both US and European-domiciled funds, so the biggest problem for us would be if trading on a SEF didn't keep us compliant with European rules, or vice versa. So for me, based in the US, if I were to do a trade under CFTC rules, then I need that to be honored by Europe. That's the most important harmonization issue for me. Beyond that, if there is any regulatory arbitrage available then I think that will get worked out over time, so in that respect there will be harmonization.

Burns: Divergent regulation between Europe and the US has led to a bifurcation of liquidity where trading has been delineated along national lines. It is likely that liquidity will remain fragmented until the regulatory environment is less uncertain. In Europe, we are still awaiting the Level 2 details of organized trading facilities under Mifid. The global nature of the FX market means that infrastructure and processes need to be as harmonized as possible to enable firms to trade quickly and efficiently with their global counterparts. ■

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