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Path Forward for Centralized Execution of Swaps

The Group-of-20 (G-20) member countries agreed at their Pittsburgh Summit in 2009 to reform the derivatives markets by requiring (among other things) that all standardized derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate.

That agreement is now starting to be reflected in regulations for centralized (as opposed to bilateral) trading of derivatives. Rules developed by the Commodity Futures Trading Commission (CFTC) are already in force in the US, and the European Securities and Markets Authority (ESMA) is working to flesh out the details of a European regime under the revised Markets in Financial Instruments Directive (MIFID II).

ISDA believes it is critical that, as G-20 members move through the process of translating the 2009 objectives into specific rules, they adhere to a set of common principles. Such an approach is essential if the respective rule sets are to both properly reflect national concerns in rule-making systems and avoid regulatory disparity – which will lead to market fragmentation, low trading liquidity, regulatory arbitrage, duplicative compliance requirements and, ultimately, increased risk.

Analysis conducted by ISDA underscores these concerns. Under US swap execution facility (SEF) rules, which came into force on October 2, 2013, electronic venues that provide access to US persons are required to register with the CFTC. The first derivatives products were mandated to trade on these platforms from February 15, 2014 – a process known as made-available-to-trade (MAT). All US persons are now required to traded MAT instruments on registered SEFs or designated contract markets, but similar rules are not yet in place elsewhere.

A clear split in liquidity has emerged as a result. For instance, European dealers have opted to trade euro interest rate swaps with other European dealers rather than be subject to US rules. By December last year, 85% of euro IRS transactions were traded between European entities, up from 71% in September 2013, before the SEF rules came into force[1].

One of ISDA's major concerns is that this market fragmentation will continue and broaden as US and European regulators fail to reconcile their rule sets. This could prompt difficult and intractable negotiations as to which rule set should prevail[2]. The CFTC attempted to find a solution to the fracturing of liquidity in February 2014, issuing conditional no-action relief that allowed US entities to continue trading on European multilateral trading facilities (MTFs) that hadn't registered as SEFs, so long as those platforms met requirements that were virtually identical to those applied in the US. This was considered too onerous by European venues, and the so-called qualifying MTF regime never gained traction.

[1] ISDA's cross-border fragmentation research series is available at http://www2.isda.org/functional-areas/research/research-notes/

[2] Absent a substituted compliance regime, it will become even more challenging to execute trades in global derivatives markets once Asian and other regulators implement their execution rules. For example, under Japanese rules, counterparties will be required to execute certain products on electronic trading platforms starting from September 1, 2015. Those electronic trading platforms will have to register with the Japanese Financial Services Agency

It is therefore especially important for regulators to achieve mutual recognition based on substituted compliance that incorporates a set of common principles to ensure regulatory consistency across jurisdictions, proper oversight, transparency and continued competition. Regulators should strive to avoid duplicative compliance obligations and regulatory arbitrage. ISDA, its members and thousands of markets participants support and need swaps markets that are not divided by regulation, but are united to create a single pool of liquidity.

Principles for Centralized Execution of Swaps

1. **The trading liquidity of a derivatives contract (and consequently the regulatory obligations to which the contract is subject) should be determined by reference to specific objective criteria.** A lack of objective criteria introduces uncertainty into swaps markets and makes it difficult for regulators to have any meaningful regulatory oversight over the process for determining the types of trades that will be mandatorily traded on centralized trading venues. This process should be based on concrete, transparent and objective standards, such as liquidity data, so that market participants have a clear understanding of when swaps will be mandatorily moved from the bilateral market to centralized trading venues. Without specific objective standards, the entire market can be subject to the trade execution mandate, including illiquid markets, which may lead to serious market disruptions.

2. **Derivatives contracts that are subject to the trading obligation should be able to trade on a number of different types of centralized venues.** The derivatives markets do not have a set domicile; these markets are global and diverse. It is therefore especially important for regulators to achieve a flexible trade execution regime that would allow contracts to be traded across jurisdictions, and not be subject to costly duplicative compliance obligations and regulatory arbitrage.

3. **Trading venues must offer flexible execution mechanisms that take into account the trading liquidity and unique characteristics of a particular category of swap.** If parties are strictly limited to a 'take-it-or-leave-it' realm of electronic execution, they will be deprived of a useful price discovery tool, and will not be able to meet their trading needs because of the unique characteristics of a particular swap. We believe that regulators will encourage centralized trading by permitting parties to communicate and execute trades freely, so long as the parties comply with the requirement to execute trades on a centralized venue.

It is instructive to consider these principles in the context of the CFTC's SEF rules, which are the only fully formed rules available at this time. ESMA's proposed rules for a European trading obligation – due to come into force in 2017 – are used as a comparison.

Application of Principles to CFTC Rules

US regulations are not aligned with the principles, as regulators embraced the concept of promoting centralized trading of derivatives in the most restrictive way. By contrast, European regulators appear to be ready to offer some regulatory flexibility and will allow derivatives to trade on several trading venues with various execution mechanisms.

ISDA's assessment, taking into account a broad range of views from its membership, is that certain regulatory changes need to be made to the US trade execution rules in order to comply with the ISDA principles and to achieve a harmonized international regulatory regime. These regulatory adjustments can be grouped into two basic categories:

- Requiring versus promoting pre-trade transparency on a SEF: The process for making mandatory trade execution determinations in the US must be changed so it is based on a set of objective criteria that is supported by applicable data. Unlike the CFTC, ESMA will determine whether certain contracts should be subject to a trading obligation.

- A flexible approach for defining what constitutes an organized exchange: To be comparable to European trading venues, the CFTC should revisit certain aspects of the SEF rules to: a) allow flexible execution methods on a SEF; b) permit flexible execution of block trades; c) simplify confirmation requirements for non-cleared swaps that are traded on a SEF; and d) re-examine the obligations of SEFs as self-regulatory organizations (SROs).

The rest of this paper examines these topics, outlines specific issues, and highlights possible items for discussion with the regulators.

Requiring versus Promoting Pre-trade Transparency on a SEF

European and US regulations are both intended to improve pre-trade transparency, but they differ in how they go about achieving this goal.

Although the Dodd-Frank Act viewed pre-trade transparency as one of the goals of centralized swaps trading, the CFTC turned this goal into a requirement by essentially forcing all mandatorily cleared swaps to be traded on a SEF. The effects of this obligation are now being felt, with markets fragmenting along geographic lines. Geographic splits in swaps liquidity pools harm full transparency in global derivatives markets. With some US dealers trading away from SEFs through their non-guaranteed foreign affiliates, SEFs do not provide complete pre- and post-trade information about products that are subject to the CFTC trade execution mandate.

To complicate things further, the CFTC's MAT rule allows a SEF to decide whether a swap is subject to mandatory trading based solely on subjective factors that a SEF deems relevant, while ignoring other considerations that may be of vital importance to the trading liquidity of a particular contract. A lack of specific objective criteria for determining trading liquidity introduces uncertainty into the market, and makes it virtually impossible for the CFTC to have any meaningful regulatory oversight over the trade execution mandate.

Having MAT determinations made by the CFTC will eliminate the competitive motivation for one platform to determine that a particular swap should be traded on a SEF and therefore force other SEFs to list this product as a mandatory traded swap. The MAT determination criteria should be based on global minimum volumes of daily trading over a significant period of time for each swap, and the CFTC should periodically re-evaluate the liquidity characteristics of a swap to determine whether it should continue to be mandated for SEF trading. The CFTC's analysis must be based on the trading data it receives from swap data repositories.

In comparison, ESMA will require swaps that are subject to the clearing obligation and have sufficient trading liquidity to be traded on organized trading facilities (OTFs), MTFs or regulated markets. ESMA will have six months following the introduction of any clearing obligation to establish whether a trading obligation would be suitable for that instrument class.

In response to ESMA's December 2014 MIFID II consultation paper, and based on an analysis of available swaps data, ISDA proposed that a class of derivatives instrument should trade at least 15 times per day in order to be classified as liquid. Given the regulatory disparity in assessing trading liquidity, it may be useful for ISDA to engage with the CFTC regarding these issues.

Flexible Approach for Defining What Constitutes an Organized Exchange

The Commodity Exchange Act (CEA), as amended by the Dodd-Frank Act, defines a SEF as a trading platform where market participants "have the ability to . . . trade swaps by accepting bids and offers made by multiple participants . . . through any means of interstate commerce . . .." CEA section 1a(50).

Despite such a broad definition, the CFTC SEF rules contain unnecessary restrictions on swap execution mechanisms. This makes it difficult to achieve the broad goal of global swaps trading envisioned by the G-20 member countries.

Unlike the CFTC, ESMA intends to offer flexible execution venues. Derivative contracts that are subject to the trading obligation can be traded on a number of centralized venues, including OTFs, MTFs and regulated markets. OTFs offer the least restrictive methods of execution and are designed to include much of the interdealer market, including voice-brokering services.

To avoid market fragmentation and maintain a robust liquidity in swaps contracts, the CFTC should address some of the most pressing SEF issues. Although complete global harmonization of execution rules is unlikely, adjusting the SEF operating model could clear a path to achieving a substituted compliance regime for derivatives trading.

Allow Flexible Execution Methods on a SEF

Permitting flexible methods of execution will help participants execute trades in more volatile periods, when liquidity falls in response to changing market conditions. Preserving the ability of a trader to execute by phone is especially important when markets are less liquid.

ISDA has consistently maintained that there is no statutory or policy basis for the CFTC to:

- Classify trades that are subject to the trade execution mandate as *Required Transactions*;
- Force *Required Transactions* to be traded via very rigid execution methods (an order book or request-for-quote to a minimum of three market participants (known as RFQ3) that operates in conjunction with the order book); and
- Require SEFs to offer an order book for contracts that are not subject to the trade execution mandate.

These requirements are in direct contradiction to Dodd-Frank's goal of promoting trading on SEFs, and the US Congress's general principles-based approach to the regulation of SEFs.

The SEF rules unnecessarily restrict acceptable methods of swaps execution. Forcing the use of an order book or RFQ3 system may not be possible for the liquidity profile of some swaps.

One of the distinct characteristics of swaps markets is variable liquidity, which can be tied to various market and economic conditions. Some instruments (even those that are subject to an execution mandate) trade only a few times a day. Requesting a price quote for these swaps via an order book or RFQ3 could therefore create information leakage, which, in turn, leads to artificially wide spreads.

In this case, the requirement to provide pre-trade transparency is detrimental to customers who are intended to be the primary beneficiaries of the efforts to increase pre-trade transparency.

The CFTC rules should allow for execution methods that take into account the available liquidity in the market and potential consequences of a wide dissemination of the request. Offering other execution methods, such as auctions, volume matches and various hybrid voice systems, will foster liquidity across a broad range of swaps markets.

Permit Flexible Execution of Block Trades

The CFTC rules requiring a block trade to be executed 'away' from the SEF platform creates an arbitrary distinction between on-SEF and off-SEF trading that is not supported by the CEA and makes it difficult to execute large transactions.

Package Trades

Unreasonably complex regulations have decreased the ability of market participants to execute package transactions that contain a mandatorily traded swap. Both users and SEFs have difficulty determining the requirements to execute package trades. Given the ambiguous MAT process, market participants struggle to determine whether a particular swap that is part of a package trade is intended to be subject to the trade execution mandate.

In addition, the CFTC must clarify that for a package transaction to be entitled to block trade treatment, only the MAT swap component(s) of the relevant package should meet the applicable block level requirement, and the whole package transaction should be subject to the reporting time delay. Such clarification will provide certainty to market participants and will encourage trading on SEFs.

Simplify SEF Confirmation Requirements for Non-cleared Swaps Traded on a SEF

Footnote 195 in the SEF rules requires SEFs to obtain, prior to the time of execution, paper copies of the privately negotiated master agreements between counterparties to a trade in non-cleared swaps. As a result, SEFs will have to request, store, manage and consult numerous complex bilateral agreements.

This requirement is in direct contravention of normal market practice, in which the vast majority of swaps are confirmed electronically. In addition, this requirement discourages trading of swaps on SEFs.

Re-examine SEFs' Obligations as SROs

It is important to recognize that the US Congress created SEFs as trading venues that are separate and distinct from futures exchanges. Congress did not intend SEFs to become SROs. SEFs cannot comply with some SRO-like requirements due to their limited market function.

The financial resources requirements for SEFs need to be more flexible. SEFs do not hold or carry risk and therefore only need to have sufficient financial resources to discharge their responsibilities and wind down their operations, if necessary.

The CFTC should define the financial resources requirements more broadly to include anything of value at the SEF's disposal, such as its parent company's financial resources, even if the CFTC does not have jurisdiction over the parent company.

In addition, a SEF should not be required to monitor other markets for manipulation. SEFs do not have, and cannot be expected to obtain, sufficient information about other market-places. SEFs should only be responsible for their own market-place.

The CFTC must adopt less prescriptive rules and focus on a more principles-based regime that provides SEFs with reasonable discretion to develop and implement appropriate rules to carry out their functions.

Providing flexibility over how SEFs comply with their regulatory responsibilities will reduce trade execution costs, promote trading on SEFs, and will narrow the gap between the US and European regulatory requirements.

Conclusion

To implement the G-20 policies based on equivalence and substituted compliance, the assessment of a country's trade execution regime should consider the regulatory outcomes of that regime, taking into account the different frameworks and local market practices across jurisdictions. The trade execution regime in the US will not be able to achieve these policy outcomes unless the CFTC reconsiders its restrictive approach to swaps trading.

ISDA has a vital interest in fostering trading in swaps and preserving a single liquidity pool. Therefore, ISDA intends to re-engage with the CFTC in addressing the issues that provide roadblocks to an effective substituted compliance regime.

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ABOUT ISDA

Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 67 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.