SEFs – What's Next?

Podcast Transcript (April 2014)

Hello, my name is Lynn Strongin-Dodds, I'm a reporter for DerivSource, and today we're going to talk about SEFs. We are going to hear from an industry expert: Sassan, can you please give us some information about yourself?

Yes, sure. I'm Sassan Danesh, I'm managing partner of Etrading software. We specialise in market structure issues in the OTC space and of course the big areas we're involved with at this stage are the OTC derivatives markets, both in the US and Europe.

The first question we will be looking at today is when SEFs started in February, the volume of derivatives through the new platform plummeted by one third as traders waited to see how the new system would work. However, buy-ins have rebounded with data and flow concentrating among the top three players. The question here is: do you think this trend will continue, and what is the outlook for the new players?

I think in the short-term the trend will continue and I think there are two aspects to this. One aspect is looking at the impact on the platforms, and you're quite right that liquidity has stayed within the incumbents. There's a good reason for this; effectively the industry's business model has not changed significantly since the SEFs go live. It's still dominated by the RFQ workflows, and whilst that remains the case it would be difficult for new platforms to gain share. But that doesn't mean that there's been no change within the incumbents. One of the big areas of opportunity for the existing platforms is actually on the inter dealer/broker side, so platforms such as ICAP, BTC, GFI, Tullett and Tradition, those guys, have now all of a sudden had the opportunity to go out and look for not just their dealer clients, which is their core franchise, but also potentially get liquidity from the more tech-savvy buy-side and also hedge funds. That's the big change that will over time have a big impact on the market. It will be over time, it will be slow, but that's a big platform structural change.

There's a second aspect to that question though, and that's more, not looking at the platforms but looking at the impact on the buy-side, sell-side and hedge funds. There's no question that HFT shops, or at least a portion of the HFT community, do want to become providers of liquidity. If their niche is likely to be for the benchmark IRS and the liquid credit indices, so I think for a certain portion of the swaps world there is an opportunity here as we look further out to see new entrants and new players. Their challenge is going to be that it takes time to calibrate their pricing and risk engines to manage swaps as opposed to, for example, listed derivatives. So it's not surprising that the process has been slow, but the direction of travel I think is clear for those very liquid interest-rate swaps and also for liquid credit indices there is opportunity here for new entrants.

Who do you see entering the market: is it the small niche players, and what do you think will happen to some of the mid-sized players?

I think there is a challenge for the mid-sized players just because you need to have some kind of edge. For the specialist that's easy, they just focus very specifically on certain areas, and of course the big-flow dealers can fall back on that volume and their client franchise. So I think the mid-players do need to bring something specific. There is still a place for them; for example, large regional can fall back on their geographic franchise. So there are certain opportunities for the mid-sized players but it tends to be more in the context of looking at what they're strong at and focusing on that.

I think for the smaller players in terms of the hedge funds etc I was talking about, it's more bringing their expertise from some of the listed markets into play within either swaps, or swap futures. They've already built a reasonably sized infrastructure for trading those kinds of products very aggressively, and to bring that infrastructure to play in the swaps world. It will only work for the liquid products though.

Overall, how do you see volumes in the future?

They will go up. Obviously we had the initial significant drop and then a significant rebound; that was a one-off, but I think over time one interesting aspect will be on a On-SEF versus Off-SEF and just how much can stay off-SEF, if you like. In my view, as the community gets more used to the On-SEF trading and starts to calibrate their own trading models, we will see a continued increase on SEF trading.

Thank you. Question two is really looking at the cross-border of fragmentation. A recent report from ISDA showed there is a transatlantic split for buy-ins within Europe and US deals falling 77% since the introduction of US rules. It's also said there will be a greater price volatility and a "shifting in the nature of trading from cleared bilateral risk management". Do you think this will continue or are you seeing this type of fragmentation as well?

Yes. It definitely exists and it is likely to continue. At the really big picture level, the issue is how well European and US legislators can cooperate together. I think recently that level of cooperation does seem to have improved but there is a challenge here there because MiFID II is so far behind Dodd Frank, you know we're talking two years, that kind of level, that a lot of what's going to be in MiFID II is at this stage unclear. The details are just not there.

So, in that context given that the thrust of the idea of having a single liquidity across the two regions is all based around having roughly equivalent regulations in place, but the challenge is more for the CFTC in the short-term to tentatively grant various no-action relief to allow European actors to access US liquidity. It's probably more that way round at this stage because MiFID II is behind Dodd Frank.

The real challenge is when you look at it like that, then in practice the level of no-action relief that the CFTC is willing to consider is nowhere near sufficient to allow an aggregation of the liquidity pools in the short-term, so of course there are various areas that they are looking at to simplify and perhaps qualifying MTS and so on. But really the big picture is that we should be resigned to the fact that there will be a separation of liquidity and that means that there will be occasional increased volatility and pricing anomalies between the two different markets.

Are you hopeful that cooperation has increased?

I think the change in management in the CFTC has had an impact and I think also from the ESMA side, from Europe, as we're now in what's called Level II of the ESMA discussion, as the MiFID II regulations start to get into the detail and is being worked on it's easier for the European regulators to have those substantive discussions with the CFTC. So one is the practical reasons that MiFID II is progressing it's easier to then have the discussions that are necessary. I think the other one is the new management on both sides are more attuned to cooperation than perhaps was the case a year ago.

In the meantime you will find that MiFID II is two years away. Do you think this will continue for the next two years?

I think for quite some time [laughs]. At least, the way I look at this, it would be a very good idea for everybody to plan on the basis that those liquidity pools will not be as synced up as they should be, and to work on that basis.

Right. So the volatility will continue?

Yes, and the associated pricing anomalies. In a way, we're used to now thinking about the capital market as a global market, which means that typically it's rare to find pricing anomalies. Well, we're likely to find those pricing anomalies, especially in periods of market stress.

So that status quo for a while?

Yes.

Thank you very much for your time, I certainly appreciate it.

Pleasure. Thank you for inviting me.