The US and Europe are taking different paths to regulate the swaps trading market. It won't matter, if they end up in the same place, writes **Kevin McPartland** of TABB Group

Different strokes

Is the "beautiful game" called soccer or football? Should swaps be traded on Swap Execution Facilities (SEF) or Organized Trading Facilities (OTF)? For that matter, should "organised" be spelt with a "z" or an "s"? While some of these debates are as old as the US Declaration of Independence and others are brand new, they highlight the differences between how Europeans and Americans approach the rules. The real question, however, is whether these differences matter.

The G20 members agreed that there could be advantages to regulating trading activity itself and that the industry should push as much of the over-the-counter (OTC) derivatives market on to those platforms as possible. They envisioned that not only traditional exchanges, but essentially any trading platform (preferably an electronic one) could be regulated by the local regulatory authority. The US embraced this concept and included a requirement in the Dodd-Frank Act that: "With respect to transactions involving swaps subject to the clearing requirement … counterparties shall … execute the transaction on a board of trade designated as a contract market … or … execute the transaction on a swap execution facility…"

The European Commission's (EC) proposal on OTC derivatives lacked a similar so-called trading requirement. For the Europeans, anything that can be cleared must be cleared and all OTC derivative transactions must be reported. But trading, it seemed, was not viewed in Europe as important to reducing systemic risk. The greatest fear of major US banks apparently had come true even after months of lobbying efforts – with US laws much more stringent than those in Europe, swaps trading was leaving for London and we'd all have to go with it or find another line of work.

But insiders in Europe knew different. In hindsight, it seems that many in the US didn't quite understand how European regulatory reform worked and that certain issues were to be dealt with separately.

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Enter the Mifid review. Remember the original Mifid? The Markets in Financial Instruments Directive is what allowed new trading venues, called multilateral trading facilities (MTF), to pop up all over Europe and wrestle market share away from the incumbent equity exchanges. The likes of BATS, Chi-X and other new pan-European venues ultimately drove the once dominant London Stock Exchange into a marriage with the Toronto-based TMX Group and encouraged Deutsche Börse and NYSE Euronext to merge.

From the beginning, a review of Mifid was scheduled for a few years after the initial implementation. The intention was always that Mifid would ultimately cover much more than the equity market – hence the "Financial Instruments" in the title. But it goes without saying that a lot has changed since Mifid was first approved in 2007 and the new proposal brings about more sweeping front-to-back reform across a much broader list of asset classes including, of course, the trading of OTC derivatives.

So, it turns out that Europe will likely have a swaps trading requirement after all. More precisely: "the Mifid framework directive could be amended to require all trading in derivatives which are eligible for clearing and sufficiently liquid to move either to Regulated Markets, MTFs, or a specific sub-regime of organised trading facilities…"

With that statement, we see that the US and Europe are going down similar paths. But, as with all things as complex as the swaps market, different – albeit equally intelligent – people will undoubtedly find different solutions to the same problem. That takes us back to my original question: do these differences matter?

Kevin McPartland – Résumé

2007 - Present	TABB Group, senior analyst
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How to trade

US regulators have come to agree that dictating the exact method by which swaps must be traded on a SEF is not a good idea. A lightly-disseminated draft proposal from the Commodity Futures Trading Commission (CFTC) included a requirement that the most liquid swaps contracts needed to trade in a central limit order book – an attempt to mimic the current approach used for exchange traded products everywhere in the world. Thankfully, this requirement was removed from the official release a week later.

The International Organization of Securities Commissions (Iosco), in the not-so-creatively titled "Report on the Trading of OTC Derivatives", recently published its views on how the use of regulated traded platforms will impact the swaps market. Iosco's findings matched the decision made by the CFTC and the report concluded that "a flexible approach to defining what constitutes an organised platform for derivatives trading" was in everyone's best interest.

Mifid II takes a similar stance on trading style, requiring only that venues "have dedicated systems or facilities in place for the execution of trades". But in this case, the devil is very much in the detail. In an attempt to support the G20's request for transparency, the Mifid II proposal goes on to state that venues "would be required to make their quotes both in terms of price and volume available to the public". In practice, this would require request for quote

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(RFQ) responses to be made public – also known as the "transparent RFQ".

It sounds sensible, but with that model, the mere presence of a price quote for an instrument that may only trade once a week will alert the market that someone is trading in that particular instrument. This awareness opens the door for aggressive firms to use that information to trade against the firm that initially requested the quote.

A gaping hole for gaming the market is not a good way to kick off a new regulatory regime. Transparency is good; liquidity-killing information leakage is not.

Promote or require?

That brings us to another difference in approach – the need for pre-trade and post-trade transparency. There is little debate about post-trade transparency. Concerns exist around how quickly a trade must be reported and exactly what

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details must be reported, but by and large, post-trade reporting is common across nearly every regulated financial market and no one expects the swaps market to evade that requirement.

The EC and the CFTC see value in pre-trade price transparency as well, but what they expect of the swap venues in this regard is different. The CFTC states that a SEF must "promote" pre-trade price transparency whereas Mifid II would "require pre- and post-trade transparency for all trades in specific non equity products, whether executed on regulated markets, MTFs, organised trading facilities or OTC".

Requiring rather than promoting pre-trade transparency leaves many market participants uneasy. In liquid exchange-traded markets, pre-trade price transparency comes naturally as a side effect of the order book model. Since market-makers are always posting prices to the screen (in many cases they are obligated to do this), it is possible for a potential buyer or seller of that instrument to get an idea of the current market price for the instrument before deciding to interact with the market. In traditional OTC and RFQ markets, it's not so easy.

The swaps markets that these rules intend to reform are relatively illiquid, with some instruments trading only a few times a day, or even a few times a month. The only way to get the current market price is to value it yourself (which may not reflect what others are willing to pay) or ask someone to. Asking for a price via the phone, an RFQ platform or some similar method, constitutes interacting with the market, which may tip off the market that you're up to something. As we already discussed, that's information leakage.

Because of this distinction, mandatory pre-trade price transparency would undoubtedly drive the use of the order book model even in places where it wasn't suitable for the liquidity profile of the product. Forcing the use of an order book model would then require dealers to post continuous two-sided quotes. For dealers to safely post two-sided quotes, they would need to keep spreads artificially wide, since it's the only way to limit their downside risk as a market maker. Artificially wide spreads mean that for a trade to be done, a phone call would still be required to get the "real" price. Even if quotes posted to a SEF had to be firm, no one would execute there because they would know that a better price exists under the covers. That being the case, even with an order book model, pre-trade transparency doesn't really exist as the posted prices create only a range, not the current market price.

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The point is that pre-trade price transparency can be very helpful to growing a market but it's not always possible. By all means we should promote it, but it's in no one's best interest to require it.

When will this be settled?

I've only scratched the surface. The US and Europe are following the same guidelines – those put forth by the G20 – as they work to reform the OTC derivatives market, but we can't expect the end result to be identical. There is good historical precedent for this: the original Mifid in Europe and Regulation National Market System (Reg NMS) in the US had similar goals – to increase competition in the equity markets. On both sides of the Atlantic, that's exactly what we got, but the approaches were very different. For example, Reg NMS was quite prescriptive about trade execution and pricing, while Mifid took a less formal approach. These and other differences didn't drive New Yorkers to London or the French to Chicago Regulation National Market System (Reg NMS), and neither will the differences in the US and European approaches to OTC derivatives.

Unfortunately, extraterritorial differences won't be settled for some time. The US will have its final rules in July, but the implementation periods for those rules will likely span years as phased approaches are a must, considering the size of the market and the scale of the change. Europe is a bit behind the US, but not as far behind as many believe. By the time US rules are really up and running in mid-2012, the European markets will have some closure to their rules.

It would be nice if the US and Europe could agree on a single label for swaps trading venues – it would make the topic much easier to discuss – but that's unlikely. And as far as the G20 is concerned, differences in name and, more importantly, operating model don't really matter much at all. A footnote included in the G20 OTC derivatives recommendation document states: "While it is important to consider which different kinds of trading venues correspond to the G20 characterisation of exchanges and electronic trading platforms, this focus on the outcome renders the issue slightly less relevant". In other words, trading needs to be more open and transparent, but how those goals are accomplished should be left to local regulators.

If football doesn't even translate, that leaves little hope for SEF, OTF, MTF or maybe even STF. But I am digressing. As the G20 makes clear, we'll have much bigger fish to fry over the next few years. ■