

## **Will The Swap Execution Facility Change Derivatives Trading Forever Or Will It Just Be More Of The Same?**

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Legislators claim that they are seeking to transform the derivatives markets, but do they have the courage of their convictions? If the financial reform bill passed last December by the House of Representatives becomes law, the current system of voice brokered derivatives trading will continue to function largely as it does today. Despite claims that it is acting to increase derivatives trading transparency, the Senate may now also be poised to preserve the status quo. The key lies in the definition of a new type of entity: a Swap Execution Facility or SEF.

It has been almost half a year since the House passed its financial reform bill, but the Senate has only now begun to debate its version of financial reform legislation. Many of the proposals are still hotly contested, but in the area of derivatives reform at least, there appears to be substantial agreement. The House bill, the Senate bill and the substitute financial reform bill Republican Senators offered late last month, all attempt to reduce systemic risk through, among other things, increased transparency. All three proposals would require most derivatives traders to clear most derivatives transactions, and proponents of all three versions have spoken in favor of execution on exchanges or electronic trading platforms.

One commentator recently set out the argument as follows:

Central clearing is important but not sufficient to bring fundamental reform to derivatives markets. To the maximum extent possible, derivatives should be traded on exchanges (or their equivalents, such as on electronic platforms), just like futures contracts and stocks. This would have two benefits. First, exchange trading would further reduce systemic risk by exposing to the market in real time the volumes and prices of derivatives transactions, thus facilitating more accurate and timely margining by parties to derivatives contracts. In addition, exchange trading, coupled with true pre-trade and post-trade transparency, would narrow trading “spreads” (the difference between offers to buy and sell), and thus benefit the ultimate end-users of derivatives or investors.

([http://www.brookings.edu/~media/Files/rc/papers/2010/0407\\_derivatives\\_litan/0407\\_derivatives\\_litan.pdf](http://www.brookings.edu/~media/Files/rc/papers/2010/0407_derivatives_litan/0407_derivatives_litan.pdf)) R. Litan, The Derivatives Dealers’ Club and Derivatives markets Reform; A Guide for Policy Makers, Citizens and Other Interested Parties, April 7, 2010, at p. 6.)



In both the House and Senate versions of the financial reform legislation, a majority of cleared derivatives trades must be executed on regulated exchanges or on Swap Execution Facilities.

SEFs have been variously defined. In some drafts, the proposed legislation would limit SEFs to electronic exchanges with pre- and post-trading transparency. The version adopted by the Senate Banking Committee on March 15, for example, defined a SEF as:

“an electronic trading system with pre-trade and post-trade transparency in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by other participants that are open to multiple participants in the system, but which is not an exchange.”

This formulation would dramatically transform derivatives trading, much of which, until now, has been executed bilaterally between voice brokers. For instance, in the option markets for energy, it is estimated that 60% of all trading volume is executed through inter-dealer voice brokers. Through its definition of a SEF, the March 15 version of the Senate’s proposed financial reform legislation would require most derivatives trading to move onto electronic trading platforms or exchanges.

In other versions of the proposed legislation, like the bill passed by the House of Representatives in December, voice brokerages may qualify as SEFs. If the final version of the financial reform legislation includes voice brokers within the definition of SEFs, execution of derivatives trading will change little after the legislation is passed.

During the final days before passage of the House Bill, observers in the blogosphere noted the addition of voice brokerage in the SEF definition and many objected to the change. The following post from Simon Johnson’s Baseline Scenario Blog was among the first: (<http://baselinescenario.com/2009/12/09/how-to-kill-otc-derivatives-reform-in-two-sentences/>). The writer Mike Konczal compares the penultimate definition of SEF with the version eventually passed by the House in the following paragraph:

So notice any differences? First the definition of a swap execution facility has been expanded to include “a person” (different from the “or entity”). It’s also expanded to an “or trading” definition, and includes voice brokerage firms. So now we are moving from the definition of something that is a platform for swaps to be traded on to instead something that simply helps swaps get traded. This could, quite simply, be a telephone over which two people trade a derivative (with one person declaring himself to be the exchange?). Instead of changing the way business is done for reform it looks like it redefines reform as the way things are currently done, and just calls it a victory.



Today, as the Senate considers similar changes to its draft bill it's déjà vu all over again. As this Bloomberg news report explains, the definition of a SEF in the draft Senate bill, which until recently would have excluded voice brokerage, may now extend to voice brokerage as well, as the House bill did before it:

A one-word deletion in the 1,565- page Senate financial reform bill may help banks and inter- dealer brokers maintain how they trade swaps in the unregulated \$605 trillion over-the-counter derivatives market. The change is in the definition of so-called swap execution facilities, a way for banks, hedge funds and asset managers to trade private derivatives that are to be sent to clearinghouses under legislation written by Senator Blanche Lincoln, chairwoman of the Agriculture Committee. The latest version deletes the word "trading" from the term "trading facility," according to a copy of the revised bill obtained by Bloomberg News. A "trading facility," as defined under the U.S. Commodity Exchange Act, prohibits phone transactions, which is how swaps have been traded for three decades.

(<http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aKdWGdPUdDx4>; Bloomberg News: Senate Bill's Word Change May Save Swaps Phone Trades (Update1), April 29, by Matthew Leising.)

In other words, if this latest proposed revision of the SEF definition is adopted, the Senate Bill, like the House Bill, will preserve the status quo of derivatives trading and will leave the system of Over-The-Counter voice brokered execution of derivatives trading largely unaltered. On the other hand, if the March 15 version of the Senate Bill or something like it were to become law, the majority of derivatives trades will be executed on more transparent, price-efficient exchanges or electronic trading platforms and virtually overnight, the Over-The-Counter voice brokerage system for derivatives trading execution will become confined to a much smaller role.

Stay tuned . . .

