# Let's Talk about SEFs

The move to swap execution facilities could mean less liquidity and higher trading costs.

●● **BY GREGORY TAGGART**

**AS IT PUSHES AHEAD WITH** regulatory changes that promise better liquidity and price transparency in the derivatives marketplace, Washington has good intentions. First, the Dodd-Frank Wall Street Reform and Consumer Protection Act seeks to disperse systemic risk by requiring centralized clearing for clearable or standardized swaps. Then it mandates the creation of electronic trading platforms dubbed swap execution facilities (SEFs). Most swaps — both standardized and made-to-order — currently trade over the counter.

Last, Congress has asked the Commodity Futures Trading Commission and the Securities and Exchange Commission to craft detailed rules for SEFs. The proposed regulations could take effect this year. In theory, they should open the swaps market to more dealers and investors. But market participants have some reservations. "We're extremely supportive of all these efforts," says Lee Olesky, CEO of New York–based Tradeweb Markets, one of many electronic platform providers that plan to register as SEFs. "We get the policy objectives, but we need to be very thoughtful about how they're implemented because there is a lot of potential for unintended consequences."

Buy-side titan BlackRock argues that introducing SEFs too quickly and with too many inflexible rules could actually reduce liquidity in the OTC market. "That may undermine the overall market structure and the creation of deep and liquid markets on SEFs," warns Supurna Vedbrat, business adviser, global trading and market structure, at the New York–based asset manager.

Liquidity concerns revolve around two proposed requirements. The more troublesome is the CFTC's recommendation that requests for quotes go to at least five dealers on a SEF. (The SEC's one-to-one protocol mirrors OTC practice, which allows investors to request quotes from just one dealer.) Because institutional investors are obliged to seek best execution for their clients, they should be able to choose how many dealers they want to seek bids from, explains Richard McVey, chairman and CEO of New York–based MarketAxess Holdings, which also plans to register as a SEF. "Oftentimes for large transactions, the best way to achieve that is to go to just one dealer," McVey says.

Also, knowledge of a potentially large trade could lead to front-running. So the winning bid must consider adverse price movements before it can hedge, and investors have to worry that all five bids might be priced accordingly. "Effectively, that will lead to a wider bid-ask, impacting the performance end users receive," Vedbrat says.

There are similar fears about the CFTC proposal that block trades be publicly reported within 15 minutes; the commission also wants roughly 95 percent of the market to be nonblock and thus reported in real time. The result will be higher transaction costs and decreased liquidity, critics maintain. "Bigger trades shouldn't have to be reported until the close of trading because without sufficient delay, liquidity providers won't have adequate time to hedge," says James Wallin, senior vice president of fixed income at New York–based investment firm AllianceBernstein. "That undermines liquidity."

Ryan Sheftel, head of electronic market making for interest rate products at Credit Suisse, is optimistic that SEFs and centralized clearing will deliver on their promises. In the past, greater transparency has boosted trading volume. But, New York–based Sheftel cautions, regulators have never before mandated that OTC markets trade electronically. He points to the market for options on Eurodollar futures as a counterexample. "Participants in futures decided that fully electronic trading is most efficient," Sheftel says, "while those in options — a virtually identical market — voted with their feet and continue trading in the pit because they find that more efficient."

BlackRock's Vedbrat hopes regulators will settle on a flexible framework and even phase in the new rules. "We need sufficient time to properly design the changes Dodd-Frank requires, so we end up with a structure that will be able to accommodate change as the market adjusts in the future," she says. ●●

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