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THOUGHT PIECE

BREAKING UP IS HARD TO DO

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As we get closer and closer to mandated SEF trading, we keep finding little things that don't work quite the way they are supposed to. I covered some of these in previous articles, including one just yesterday. Well, it seems that the CFTC can't get out of its own way, or ours for that matter. The latest "clarification" from them relates to impartial access to SEF, and covers something called breakage agreements.

The CFTC first addressed breakage agreements in a September 26 guidance document on straight through processing (STP). This document spends a lot of time on pre-trade arrangements by FCMS, customers, and dealers. Here's some of what it says (I have redacted much of the turgid prose):

Pre-Execution Risk Management by Clearing FCMs – Regulation 1.73(a)(l) requires each Clearing FCM to establish risk-based limits for each proprietary account and each customer account that are based on position size, order size, margin requirements, or similar factors. Regulation 1.73(a)(2) requires each Clearing FCM to screen orders for compliance with those limits… Accordingly, Clearing FCMs must screen orders for execution on a SEF or DCM pursuant to either Regulation 1.73(a)(2)(i) or (ii) regardless of the method of execution.

Pre-Execution Clearing Arrangements and Clearing FCM Guarantee of SEF and DCM Trades – Regulations 1.74, 37.702(b), 38.601, and 39.12(b)(7) establish straight-through processing ("STP") requirements for FCMs, SEFs, DCMs, and DCOs respectively. A near instantaneous acceptance or rejection of each trade provides certainty of execution and clearing, reduces costs, and decreases risk… Accordingly, a Clearing FCM may not reject a trade that has passed its pre-execution filter because this would violate the requirement that trades should be accepted or rejected for clearing as soon as technologically practicable.

Effect of Rejection from Clearing – [T]he Divisions believe that any trade that is executed on a SEF or DCM and that is not accepted for clearing should be void ab initio… Experience indicates that pre-trade checks will make rejection a rare event and that STP has made the time between execution and any rejection a matter of seconds. This combination of rarity and minimal financial exposure to the parties obviates the need to have so-called "breakage agreements" between market participants. The imposition of such agreements would be an impairment to impartial access to SEFs.

Except that market participants aren't willing to enter into exchange trades without a breakage agreement, which establishes who pays for any losses as a result of breaking a trade. Of course, breaking trades can have many causes, including innocent mistakes in execution, along with the still-existing possibility that an agreed-to trade can't clear.

So the CFTC issued a guidance document on November 14, which says, in part:

The Divisions understand that some market participants' ability to interact on a SEF's trading systems or platforms for ITBC [Intended to be Cleared] Swaps is restricted by the use of so-called "enablement mechanisms." … For example, some SEFs establish that any two market participants may only execute an ITBC Swap on a SEF's trading systems or platforms if the market participants have a pre-execution agreement, such as a breakage agreement… Such restrictions are inconsistent with the impartial access requirement set forth in the Commodity Exchange Act ("CEA") and Commission regulation 37.202. These provisions require a SEF to allow its market participants to fully access its trading systems or platforms with respect to ITBC Swaps… SEFs that apply or support enablement mechanisms that allow certain participants to interact with only certain other participants, or to interact in only certain ways, while other participants have broader abilities to interact, are imposing or allowing different access terms on similarly situated participants and are therefore engaging in prohibited discriminatory treatment.

Thus, the CFTC appears to be saying that any arrangement covering who is responsible for costs if a trade has to be broken, for any reason, not just because of clearing rejection, violates the impartial access requirements. While you and I may think having such an agreement is simply good business, the CFTC appears to think it's a restraint of trade. I guess we'll have to see if ESMA gives the same clarification and, if not, whether trading volume migrates to Europe.

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George is available for follow-up calls and meetings.