ISDA Research Note

Footnote 88 and Market Fragmentation: An ISDA Survey

December 2013

Summary

Earlier this year, the US Commodities Futures Trading Commission (CFTC) required that swap execution facilities (SEFs) with temporary SEF registration status come into full compliance with all applicable SEF rules beginning on October 2, 2013.

Originally, those rules were thought to apply only to transactions that would be required to trade on a SEF. However, confusion over Footnote 88 and the definition of a US person have resulted in liquidity concerns from market participants. Footnote 88 states that "a facility would be required to register as a SEF if it operates in a manner that meets the SEF definition even though it only executes or trades swaps that are not subject to the trade execution mandate." This means that the SEF rules would apply to any transaction the SEF offered, whether or not that transaction is mandated to trade on a SEF.

These concerns prompted ISDA to conduct the SEF Market Fragmentation Survey to obtain a clear picture of potential market disruption or fragmentation resulting from SEF rule implementation.

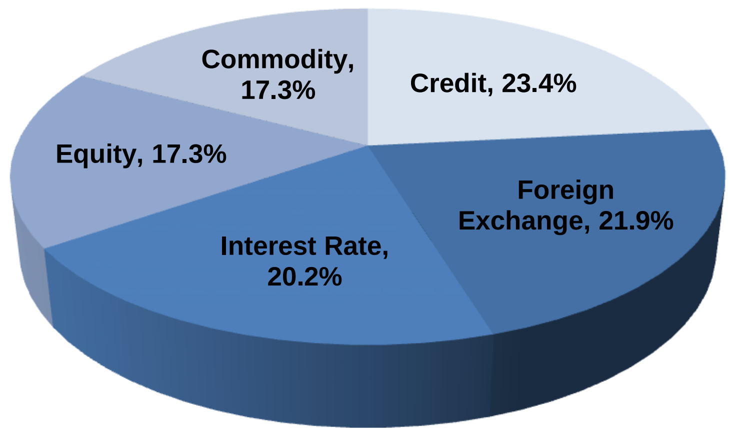
Our survey's findings reveal:

- Liquidity has been fragmented across platform and cross-border lines resulting in separate liquidity pools and prices for similar transactions.
- Several participants revealed that *total* derivative trading volume measured as a percentage of notional amount decreased from October 2, particularly in credit and foreign exchange derivatives.
- 84% of survey participants believe non-US persons are choosing not to trade on SEF platforms as a result of CFTC rules coming into effect in all swap categories: interest rate, credit, foreign exchange, equity and commodity derivatives.
- 68% of participants believe trading activity with US persons is being reduced or has ceased as a result of the October 2 rule. Over half of the responses indicate the presence of market fragmentation, such as the formation of separate liquidity pools for US persons.
- 61% of participants believe trading has been redirected from electronic to voice trading as a result of the CFTC-SEF rules coming into force.
- Roughly half of the participants believe fragmentation resulting from the SEF rule has led to different prices for similar types of derivative transactions.

Survey Participant Statistics

ISDA launched the SEF Market Fragmentation Survey on November 19, 2013. 44 participants responded to a series of questions designed to uncover where and how market fragmentation might be occurring pursuant to the October 2 CFTC-SEF rule. Each participant was asked to either (i) collect responses across his institution to address each of the derivatives categories or (ii) respond *only* to his relevant category. On average, 105 responses were received for each derivatives category. 526 responses in total were collected. Chart 1 describes the percentage breakdown of these responses.

Chart 1: Responses by Swap Derivatives Category



Credit responses represented 23% of total responses. Foreign exchange was the second largest category (22%), followed by interest rate (20%), equity (17%), and commodity (17%) derivatives.

For each question asked, the following subcategories underscored each major swap category for the purposes of this survey:

- Interest Rate: Interest Rate Swap (IRS) and Forward Rate Agreement (FRA)
- Credit: CDX Investment Grade, High Yield, iTraxx Europe Indexes
- Foreign Exchange: Non-deliverable Forward (NDF) and FX Option
- Equity: Single Name and Index Equity Swaps
- Commodity: Energy and Agricultural Swaps

Survey Responses

1. Approximately what change, if any, have you seen in total derivative trading volume (measured in notional) since the CFTC-SEF compliance requirements went into effect on October 2?

Table 1 summarizes changes in total derivative trading. The sharpest declines in volume were seen in the credit and foreign exchange categories. Over 40% of responses indicated that interest rate and equity derivatives both experienced volume declines.

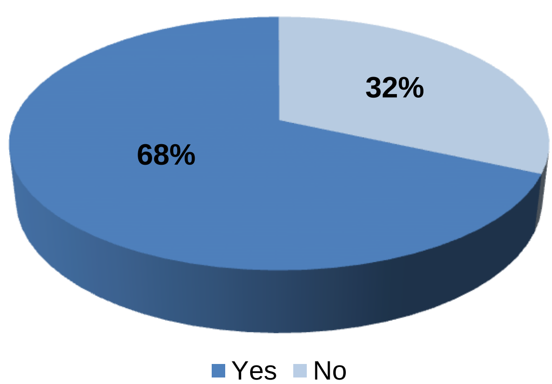
Table 1: Changes in Total Derivative Trading as of Oct 2, 2013

	>-40%	-25% to -39%	-15% to -24%	-10% to -14%	-5% to -9%	0% to -4%	No change
Interest Rate	0%	0%	24%	6%	6%	6%	59%
Credit	0%	11%	28%	22%	0%	0%	33%
Foreign Exchange	6%	6%	13%	6%	6%	13%	44%
Equity	0%	17%	11%	6%	6%	6%	56%
Commodity	0%	6%	6%	0%	0%	13%	69%

2. Are you or your clients reducing or ceasing some trading activity with US persons as a result of CFTC rules coming into force from October? If yes, to what extent would you estimate market volume with US persons has decreased since CFTC rules came into force from October?

As Chart 2 highlights, 68% of participants believe trading activity with US persons is being reduced or has ceased as a result of the October 2 rule.

Chart 2: Changes in Trading Activity with US Persons as of Oct 2, 2013



Participants in the credit, foreign exchange, equity and commodity categories indicated some portion of trading activity declined more than -40%. However, the majority of responses reveal most declines were in the -15% to -24% range as shown in Table 2.

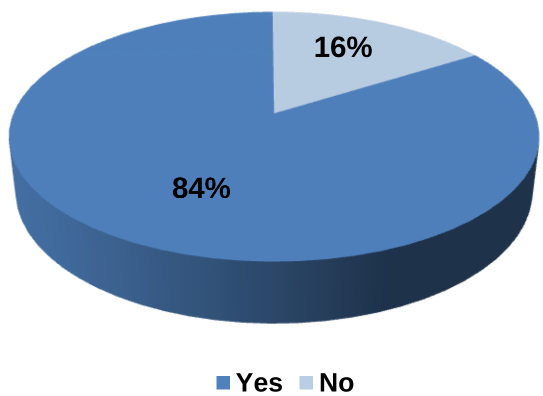
Table 2: Declines in Trading Activity with US Persons as of Oct 2, 2013

	>-40%	-25% to -39%	-15% to -24%	-10% to -14%	-5% to -9%	0% to -4%
Interest Rate	0%	0%	20%	40%	20%	20%
Credit	12%	6%	24%	18%	29%	12%
Foreign Exchange	6%	18%	24%	24%	6%	24%
Equity	9%	9%	9%	27%	27%	18%
Commodity	8%	0%	8%	8%	42%	33%

3. Do you believe that non-US persons are choosing not to trade on SEF platforms as a result of CFTC rules coming into force from October? If yes, to what extent would you estimate market volume with US persons has decreased since CFTC rules came into force from October?

As Chart 3 highlights, 84% of survey participants believe non-US persons are choosing not to trade on SEF platforms as a result of CFTC rules coming into effect in all swap categories: interest rate, credit, foreign exchange, equity and commodity derivatives.

Chart 3: Non-US Person SEF Trading Trends as of Oct 2, 2013



Responses in all swap categories indicated that some portion of trading activity declined more than -40%. The highest percentage of responses revealing these sharp declines was observed in the foreign exchange and equity categories. Although the number of responses was fairly consistent across all groups, interest rate and credit responses tended to be more evenly distributed than the other categories as shown in Table 3.

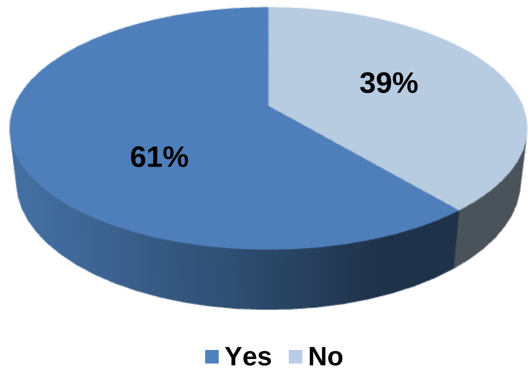
Table 3: Declines in Trading Activity with US Persons as of Oct 2, 2013

	>-40%	-25% to -39%	-15% to -24%	-10% to -14%	-5% to -9%	0% to -4%
Interest Rate	15%	8%	23%	23%	15%	15%
Credit	19%	13%	19%	25%	13%	13%
Foreign Exchange	27%	13%	33%	20%	0%	7%
Equity	50%	0%	20%	0%	20%	10%
Commodity	18%	0%	18%	0%	36%	27%

4. Has derivatives trading been redirected from electronic to voice trading as a result of CFTC rules coming into force from October? If yes, what is the approximate percentage of trading which has been redirected?

61% of participants believe trading has been redirected from electronic to voice trading as a result of the CFTC-SEF rules coming into force as shown in Chart 4.

Chart 4: Shifting from Electronic to Voice Trading as of Oct 2, 2013



Responses relating to equity (86%) and commodity (75%) categories were characterized by the most dramatic shifts in trading styles as the majority of declines in electronic trading exceeded -40% as shown in Table 4. Over 30% of participants in the foreign exchange (38%) and interest rate (31%) categories also indicated these dramatic shifts were observed.

Table 4: Declines in Electronic Trading in Favor of Voice Trading as of Oct 2, 2013

	>-40%	-25% to -39%	-15% to -24%	-10% to -14%	-5% to -9%	0% to -4%
Interest Rate	31%	8%	23%	8%	15%	15%
Credit	24%	24%	0%	6%	18%	29%
Foreign Exchange	38%	8%	15%	0%	15%	23%
Equity	86%	14%	0%	0%	0%	0%
Commodity	75%	25%	0%	0%	0%	0%

5. Has there been a fragmentation in liquidity for derivatives transactions (i.e. to separate liquidity pools for trades involving and not involving US persons) since the coming into existence of SEFs and introduction of a new definition of US person?

60% of participants indicated that they observed some degree of market fragmentation resulting from the October 2 SEF rule and the new definition of a US person. The largest percent of responses by category revealed that foreign exchange (37%) was most significantly fragmented, followed by equity (19%) derivatives. Table 5 characterizes the degree of market fragmentation by derivative category.

Table 5: Cross-border Market Fragmentation as of Oct 2, 2013

	No Fragmentation	Some Fragmentation	Significant Fragmentation
Interest Rate	38%	63%	0%
Credit	26%	68%	5%
Foreign Exchange	21%	42%	37%
Equity	56%	25%	19%
Commodity	67%	27%	7%

6. If there has there been a fragmentation in liquidity for derivatives transactions, has that fragmentation led to different prices for similar types of derivative transactions?

46% of participant responses across all derivative categories suggested market fragmentation has led to different prices for similar types of derivative transactions. The foreign exchange category had the most responses (67%) of all groups indicating that price differences existed. Both equity and commodity categories contained responses suggesting such price differences were significant. Table 6 describes the breakdown of derivative category responses by the degree of variation in prices of similar transactions.

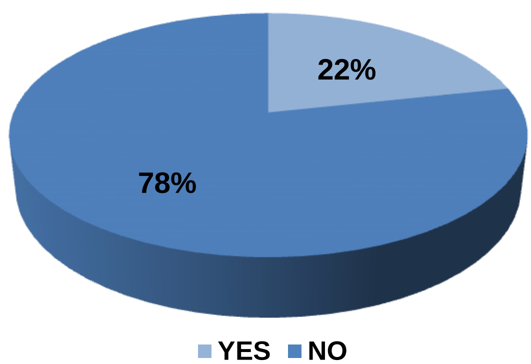
Table 6: Price Dispersion Effect of Market Fragmentation as of Oct 2, 2013

	No Difference	Some Difference	Significant Difference
Interest Rate	60%	40%	0%
Credit	53%	47%	0%
Foreign Exchange	33%	67%	0%
Equity	64%	21%	14%
Commodity	69%	23%	8%

7. Has fragmentation led to other market effects across derivative categories?

Roughly one-fifth (22%) of participants believe that market fragmentation resulting from the October 2 SEF rule coming into force has had spillover effects across derivative categories as shown in Chart 7.

Chart 7: Spillover Effects of Market Fragmentation as of Oct 2, 2013



8. If fragmentation has led to other market effects, please describe these effects, or expand upon answers provided in the survey.

Participants added individual comments relating to the above question. The following summary describes some of the main takeaways:

- Generally speaking, liquidity effects stemming from market fragmentation affect client flows by increasing costs.
- Confusion amongst the dealer community is characterized by different opinions regarding which products, scenarios and requirements are in scope of SEF compliance.
- Regulatory uncertainty has prompted non-US persons to become extra cautious of violating CFTC rules, thus destroying trading and liquidity in markets where these non-US persons typically participate.
- In foreign exchange, there has been fragmentation in workflow resulting in traders becoming reluctant to show prices and provide liquidity.
- The environment in credit has become one where liquidity drains away quickly and erratic price movements occur on little to no volume.
- Institutional market participants who have adopted swaps due to their increased liquidity and transparency, such as the asset management community, may turn away thus affecting public investment.
- Potential second order effects such as market volatility, stress and the frequency of failed trades should be monitored.
- Further market fragmentation is expected in February 2014 when the CFTC's 'made available to trade', or MAT rule, comes into play.

Conclusion

The October 2 effective date for SEF compliance and the Footnote 88 interpretation are clearly having an impact on trading volumes – and the nature of trading activity – in the OTC derivatives markets. Market participants report that liquidity has fragmented. More trades are being done bilaterally and via voice. Trading between US persons and non-US persons is disrupted.

ISDA® Research Note

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About ISDA

Since its founding in 1985, the International Swaps and Derivatives Association has worked to make over-the-counter (OTC) derivatives markets safe and efficient.

ISDA's pioneering work in developing the ISDA Master Agreement and a wide range of related documentation materials, and in ensuring the enforceability of their netting and collateral provisions, has helped to significantly reduce credit and legal risk. The Association has been a leader in promoting sound risk management practices and processes, and engages constructively with policymakers and legislators around the world to advance the understanding and treatment of derivatives as a risk management tool.

Today, ISDA has over 800 member institutions from 60 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers.

ISDA's work in three key areas – reducing counterparty credit risk, increasing transparency, and improving the industry's operational infrastructure – show the strong commitment of the Association toward its primary goals; to build robust, stable financial markets and a strong financial regulatory framework.

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