The OTC Derivatives Market

Achieving high performance in the new regulatory regime
Executive summary

We believe that in the storm of debates on the proposed reforms in the over-the-counter (OTC) derivatives market, mandated under the Dodd-Frank Act (DFA), there is a risk that market players are losing sight of the immense opportunities for sustained differentiation as well as the low-hanging fruit in the anticipated new environment.

The main question troubling the market is whether the proposed rules for Swap Exchange Facilities (SEFs) or Organised Trading Facilities (OTFs) would adversely alter the structure of a fairly liquid and flexible market. Our experience with leading market players leads us to believe that the question will need to be asked differently: How can SEFs or OTFs further improve the market liquidity and flexibility and what are the opportunities that the sell-side and buy-side participants can seize to stay ahead in the market?

As the final rules are being drafted, high-performance businesses will be distinguished by their ability to build flexibility into their technology investments to ensure stable and robust technology. Successful SEFs/OTFs will be those with the technology to provide error-free, real-time price dissemination and the ability to support Order Book or Request for Quote models. Technological excellence will then become a differentiating factor for the selection of the SEFs/OTFs that will dominate the market.

The DFA is compelling every participant to re-evaluate the way they operate in the marketplace. For example, against the backdrop of price transparency (the inevitable result of the electronification of the market), successful players will find opportunities for price aggregation across multiple execution venues to allow their clients access to a wide range of liquidity via a single platform. In this Agency model, the sell-side would act as an executing broker, aggregating SEF data flows and submitting orders to the SEFs on behalf of their clients. Indeed, there will be many such opportunities for value-added, differentiated services that could provide competitive advantage. A few are already investing to build these services.

The SEFs/OTFs will transform the OTC derivatives market, creating an environment that will level the playing field between the buy-side and the sell-side, and result in greater market efficiencies and transparency. Such an enabling environment will provide the opportunities for success. But the right technology and processes as well as the flexibility of technology investments will be the key to sustained competitiveness.
Introduction

These are chaotic times for the over-the-counter (OTC) derivatives market. A new regulatory regime is expected to bring in sweeping changes, the impact of which is uncertain as the rules under the Dodd-Frank Act (DFA) are still to be finalised. As the market looks set for fundamental structural transformations, it faces challenges that could be overwhelming. What then are the possibilities for differentiation for all market players in such an evolving architecture?

This is a question that some of the leading players are already addressing. However, for many others, the concerns around liquidity and flexibility in the marketplace that were first raised in September 2009—when G20 leaders agreed that all standardised OTC derivatives contracts will be traded on exchanges and Swap Execution Facilities (SEFs) or Organised Trading Facilities (OTFs), processed through clearing houses (CCPs) and reported to repositories—remain unmitigated.

As the US$708-trillion OTC market gears up for a new paradigm, market players are wary of the lack of minimum requirements of standardisation and liquidity for contracts made available for trading given the fact that not all contracts subject to mandatory clearing may be liquid. Furthermore, as all executed trades on the SEF will be known to the entire market, the pre-trade transparency may actually result in less liquidity as participants may be reluctant to take a position that will be revealed to others.

Additionally, market players fear that the proposed rule—a participant must send the request to at least five participants—will affect pricing and liquidity as dealers will hesitate to go in for aggressive pricing if the deal is also known to other dealers. One of the proposed Commodities Futures Trading Commission (CFTC) rules requires that SEFs be based on either an Order Book or Request for Quote (RFQ) trading model. Participants believe that the focus on only two categories of facilities is restrictive.

Apart from the fears about lower liquidity and flexibility, the market is also bracing itself for major technological, operational and strategic challenges for the buy-side, sell-side and SEFs themselves. The move to an electronic marketplace with real-time pricing and transaction reporting as well as interoperability across different providers (CCPs and SEFs) and market participants will be tough.

However, our experience with leaders in this market has shown that the fiery debates on regulatory issues hide the larger opportunities for competitive advantages for all players in the new regulatory scenario for OTC derivatives.

A few market leaders are already seizing the opportunities and investing in defining their position in the market. Many players that intend to become a SEF when the regulation comes into force have started investing significant resources in developing their existing interdealer platforms to support a SEF architecture. These players range from existing leading players in the interdealer market, such as ICAP, to new platform entrants, such as State Street. The sell-side participants, many tier-1 banks that have already developed a clearing broker proposition, are also starting to define their strategy for an execution broker offering. The buy-side has been more reserved thus far, with only a handful of players engaging in early testing scenarios that mimic the future state derivatives reform architecture. A few are undertaking technology infrastructure upgrades and building connectivity with the industry participants.

For their part, SEFs/OTFs will need to take into consideration the rules for the trade reporting and real-time reporting as well as the possibility of performing reference data and trade limits checks on behalf of their participants. This is because many market participants believe that the business drive for certainty of clearing and the trade reporting in swap data repositories will move some of the current middle-office functions more upfront in the workflow. In this environment, existing affirmation platforms are already considering ways to re-invent themselves as reference data repositories/providers to support SEFs/OTFs and the real-time reporting requirements. Further, as market participants will need to establish connectivity with a number of SEFs/OTFs, the opportunity could arise for new or existing market players to establish themselves as the main hub that would facilitate this connectivity across the market.

For the majority of the market players, the road map and the decision points still remain unclear. This paper aims to outline the prospects behind the technological and operational challenges for SEFs and other market players to become high-performance businesses in an uncertain environment.
SEFs: Transforming the market architecture
Although electronic trading venues for OTC derivative already exist under forms such as Multilateral Trading Facilities (MTF) or Alternative Trading Systems (ATS), their use will be broadly established across the OTC industry and new rules will govern their roles and duties. The electronification of the market will mean tighter spreads, higher volumes and lower nominal average cost per ticket (see Figure 1).

In such an environment, a high-performance business in the SEF/OTF space will be one that provides participants a broad choice of products, attracts large numbers of market makers, who have the capacity to animate the market in real time by streaming prices, submitting orders (bid-ask) and replying to the quote requests. The real-time aspects are critical for ensuring the best service and prices for clients. Only large players with an existing client base can provide this kind of service and prices, but entrants can grab the competitive advantage by focusing on a specific product subsection.

The current market proxy for a SEF or OTF can be split into two distinct parts: the interdealer market such as ICAP Plc, GFI, BGC Partners and Tradition, and the dealer-to-client (D2C) market such as Tradeweb, MarketAxess and Bloomberg. All of these players are aiming to register their current electronic platforms as a SEF and then also as an OTF when the European regulation comes into force.

But the current sharp distinction between D2C and D2D markets may blur in the post reform environment. Some D2D SEF players could find that the open access mandated by DFA may interest clients who do not currently have access to interdealer broker liquidity, reducing the option to charge spreads.

Significantly, the new regulations will drive the emergence of two new models for products that are eligible for SEF trading: Trading and Agency models. In the first model, we see the buy-side and sell-side firms submitting orders directly to the SEFs, opening the opportunity for new trading strategies, more transparent prices and direct market access. The second is an Agency model, where the sell-side attempt to retain relationships with their existing OTC clients by offering strategic value-adding executing broker services.

Figure 1. Exchange-traded derivatives market: Reducing the average cost per ticket

When considering the average cost of a trade over the course of regulatory transformation, the Bid-Ask spread on a trade is likely to fall from 42% in a Bilateral Paradigm, to less than 1% post-reform. Whilst this compression on spreads will reduce some costs, the average total trade cost will still increase overall due to the introduction of execution fees on the SEFs and the increasing margin requirements of CCP clearing. However, the introduction of SEFs over the long-term will also have a big impact on trade volumes due to the ease of market access and transparency, and the ‘electronification’ of the market allowing high frequency trading. This increase in volume will eventually lead an economies of scale and the total average cost of trade will be roughly half current levels.

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Admin / Legal Fees | Bid-Ask Spread | Clearing Fees | Execution Venue Fees | Broker Fees | Margin Fees

Bilateral Paradigm (Pre -2007) | $100 | 35% | 42% | 13% | 10% | Transformation (2007 -2010) $120 | 50% | 33% | 8% | 13% | Reform Paradigm (2011 -2013) $130 | 75% | 8% | 13% | 6% | Limit Scenario (Post -2013) $60 | 95% | 8% | 13% | 6% | 8%

Source: TABB Group, Global Risk Transfer Market, November 2011
High performance in the trading model

In this model, the process of margining will be a key concern for traders. But the complexity and costs associated with maintaining a position will provide traders opportunities for adopting innovative trading strategies. The high-performance companies in this scenario are likely to be those with business models suitable for flow markets (Flow Monsters) or specialised products (Product Specialists).

Take the case of the Flow Monsters. Centrally cleared and exchange-traded OTC derivatives are ideal products for Flow Monsters because typically Flow Monsters process huge trade volumes at extremely tight spreads and have the right capabilities for competitive pricing. This business model could provide liquidity on all available SEFs, all asset classes and eligible instruments at high volumes. Flow Monsters have the capacity to compute a large range of prices in real time and can manage hundreds of orders/quotes across several SEFs. Additionally, they have the flexibility to deal with trades on the two different models: RFQ and Order-Book (CLOB).

The Product Specialist, or the model that focuses on product specialisms, also faces strong prospects to be highly competitive in the new regime as it has the ability to provide highly competitive pricing on selected SEFs, on niche asset classes and/or selected instruments, and/or in selected regions.
High performance in the agency model

The presence of SEFs is expected to create tighter spreads, and hence lower dealer revenues, as participants can execute on the direct bids and offers made by multiple other liquidity providers. In such an environment of price transparency, successful players will be those that can implement offerings such as robust price aggregation across multiple execution venues to allow their clients access to a wide range of liquidity via a single platform. In the Agency model, the sell-side would act as an executing broker, aggregating SEF data flows and submitting orders to the SEFs on behalf of their clients.

Competitiveness will also be driven by value-added services that reduce the cost and complexity generated for clients by the regulatory reform. Many of these services will be the traditional prime brokerage execution services that are offered to clients (such as pre-trade analytics or research); however, more innovative services such as algorithmic trading/smart order routing and simplified legal documentation will differentiate agents. As volumes increase, scalable offerings become paramount, and it is here that agents will gain advantage by integrating an executing broker model with a clearing broker model to create a “full service” offering (see Figure 2).

Figure 2. Opportunities for value-added services in the Agency model

Sell-Side Agency Strategy

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<tr>
<th>Clearing Broker</th>
<th>Full-Service Execution and Clearing</th>
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<tbody>
<tr>
<td>In addition to the consolidated CCP Connectivity, clearing brokers will offer additional cross-product services:</td>
<td>As the electronification of the swaps market promotes scale, it is likely that many of the large banks will adopt a full service clearing and executing broker model, where additional EB and CB services are combined to offer a scalable full service experience.</td>
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<tr>
<td>• Netted Margins</td>
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<td>• Consolidated Real-Time Reporting</td>
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<td>• Consolidated Billing</td>
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<td>• Risk / Portfolio Management Tools</td>
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<td>• Streamlined Client Onboarding</td>
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<td>• Simplified Legal Documentation</td>
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<tr>
<th>Executing Broker</th>
<th>Bilateral OTC or No Response</th>
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<tbody>
<tr>
<td>In addition to multiple SEF connectivity through a SEF Aggregator, executing brokers will offer additional cross-product services:</td>
<td>• Some sell-side participants may choose not to respond or leave the market</td>
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<tr>
<td>• Pre Trade Analytics</td>
<td>• With exemptions for corporate end-users, the Bilateral OTC model will still exist</td>
</tr>
<tr>
<td>• Research</td>
<td>• FI clients can remain here with complicated, bespoke swaps</td>
</tr>
<tr>
<td>• Algorithmic Trading (Smart Order Routing)</td>
<td>• Some full EB and CB providers may offer bilateral services in addition to SEF connectivity and CCP clearing.</td>
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Source: Accenture Research
Technology infrastructure as the key differentiator
Market players need to explore the potential for value-added services in the two trading models to identify areas for competitive advantage. However, more importantly, our experience with clients in this industry reveals that the technology infrastructure of the SEFs/OTFs to enable connectivity across middleware platforms, clearing houses, buyers/sellers and swap data repositories will be the key sustainable differentiator. All market participants—whether in the Trading or Agency model—will require robust and scalable technological infrastructure to support volume of trades, complexity of workflows and straight through processing (STP) as the key to success will be the level of interoperability between SEFs and buyers/sellers to enable effective real-time price dissemination and trade execution (see Figure 3).

The technology solutions provided by SEFs/OTFs will also need to be flexible to adapt to regulatory changes, addition of new products and services required by their users. Indeed, the technological excellence of the execution venues, will no longer be an optional requirement, it will become a differentiating factor for the selection of the SEFs/OTFs that will dominate the market.

The front-to-back processes and workflows need to be streamlined to reduce the number of manual points and create a scalable infrastructure. The cooperation between front office and operations/technology will be a critical success factor as business decisions—such as the choice of SEF/OTF and new trading strategies—could be impaired or enhanced by the available technological infrastructure and operational procedures. For example, in the Agency model, increased STP rates and streamlined processes will improve the value-added services offered to the clients, such as real-time trade and limits dashboards or same-day transaction reporting.

Doubtless, the technology investments for setting up and connecting to a SEF will be high and could be a deterrent for smaller players and entrants. Many market players are already investing extensively to meet the new regulatory requirements and build the technological infrastructure that will enable them to operate in the new regulatory framework. The enthusiasm to invest in technology is possibly less evident for the buy-side organisations; however, the majority of the sell-side participants have started to add the likely impact of SEFs/OTFs to their evaluations of their current models and rethink their pricing strategies.

Figure 3. Interoperability and connectivity will be the key to seamless trade execution

Source: Accenture Research
The new regulation will compel all market participants to re-evaluate their business models, workflows and technological infrastructure. It is increasingly expected that the U.S. and E.U. regulators will proceed with the execution model, with tight timelines for all participants to become compliant.

Although many actors plan today to launch a SEF or OTF, only a few are likely to remain in the market over the coming years. According to leading players, it is likely that the initial rush to register as SEFs will peter out as the selection criteria and market dynamics will distinguish who the key long term players are. These criteria will be market liquidity and depth, existing technological infrastructure and established relationships.

It is clear that robust technology is a key factor in the success of the market and its participants. The infrastructure’s capacity and resiliency as well as the ability to systematically process large trade volumes without breaks in the workflow are the differentiating factors that will lead to competitive advantage.

Conclusion
Strategic SEF/OTF assessment
Working with you to identify the areas of your business most likely to be impacted by the regulatory changes and support the SEF and Executing / Clearing Broker selection

Interface build out with SEFs/OTFs
Leveraging our experience in protocol connectivity, FIX development and our industry partnerships to ensure that the integration with SEFs takes place seamlessly, and on schedule while supporting you to connect with applications such as Murex, Calypso or bespoke internal systems

Upgrades to existing system infrastructure and testing
Accenture has a proven track record of successfully enhancing/adapting trading tools (Order Management: RFQ & CLOB) and holds an extensive suite of proven testing tools and assets that enable us to accelerate delivery and ensure consistent quality

Adoption of new processes
Developing strategies and methods to support the new organisation model imposed by the introduction of SEFs/OTFs

Establishing and maintaining competitive advantage
As financial institutions move towards connectivity with SEFs, CCPs and SDRs there are opportunities to upgrade data management to meet the regulatory requirements. Accenture can help financial services firms and market participants to develop a strategic data model and data repositories, to govern the capture of more accurate data for regulatory purposes

Accenture can also help with:

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