# Securities Regulation Daily Wrap Up, DERIVATIVES—Derivatives industry participants discuss market liquidity, Regulation AT concerns, (Apr. 26, 2016)

Securities Regulation Daily Wrap Up

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In a meeting of the CFTC Market Risk Advisory Committee, derivatives industry members discussed the impact of evolving market structure on market access and liquidity. Some committee members and CFTC Commissioner J. Christopher Giancarlo reported serious concerns that liquidity has deteriorated significantly in some markets, although not all members shared the same level of concern. The committee also discussed the possible effects of automated trading on market liquidity.

The meeting was kicked off by Commissioner Sharon Bowen, the committee's sponsor, with a series of questions examining how well derivatives markets are functioning.

**Liquidity.** Commissioner Giancarlo detailed concerns about diminished liquidity across many markets and asset classes—not just those overseen by the CFTC—and resulting sharp spikes in liquidity. He said many are worried about reduced liquidity, including officials from the International Monetary Fund, the Bank for International Settlements, the Bank of England, and Federal Reserve Chair Janet Yellen, as well as financier Stephen Schwarzman of Blackstone and economists Nouriel Roubini and Mohamed El-Erian. Although some central bankers are skeptical about reports of illiquidity and point to narrow bid-ask spreads, there is evidence of deterioration in the quality of other fundamental liquidity characteristics including market depth, width, volume, resiliency, immediacy, participation and turnover. The reduction in liquidity is due in significant part to the aggregate impact of uncoordinated post-crisis regulatory policies of U.S. and overseas bank prudential regulators, said Giancarlo.

Citing a specific example of impaired liquidity, Rana Yared of Goldman Sachs said they are finding their clients reflecting that they are more challenged if they wish to do $250k of DV01, which she said is not actually that large in size. Clients are finding they have to break up the trade into multiple sizes or the price becomes enormously expensive compared to what they are used to, she said. However, Stephen Berger of Citadel disputed this assertion, saying his firm auto-quotes up to $700k of DV01, and he didn't think it is true that clients can't get $250k done.

Kristen Walters of BlackRock said that although she thinks there has been a very marked structural change in liquidity markets following the financial crisis, especially in the fixed income space, this is due to appropriate regulatory changes to stabilize the banking sector and ensure sufficient dealer capital liquidity and reduce leverage. On a daily basis, BlackRock does not experience liquidity issues in the market, given its size and investment infrastructure and electronic trading and straight-through processing systems. However, she thinks it's more difficult for smaller market participants.

Dr. Marcus Stanley of Americans for Financial Reform said that recent work shows "pretty conclusively" that liquidity has not declined in the corporate bond market. In addition, a recent Bank of England study looking at London clearinghouse transaction data in the interest rate swaps market found "very large" economic benefits accruing from increased pre-trade price transparency, as well as a reduction in interdealer trading. Regarding the impact of reduced liquidity on end users, Stanley observed that not all trading activity by end users consists strictly of hedging. In fact, a recent academic study looking at newly available derivatives accounting disclosures showed that, in one sample, two-thirds of energy company end users were using swaps for non-hedging

purposes. Most of the swaps were undertaken for earnings management, and the use of these non-hedging swaps were associated with increased, not reduced, earnings volatility, he said.

CFTC Chairman Timothy Massad noted that many forces beyond regulation shape liquidity and market structure, and any analysis should be grounded in facts, not just suppositions. He added that it's important to remember that the financial crisis of 2008, when a lot of regulations were not in place and there was no liquidity, is motivating a lot of things the CFTC is doing. Perhaps liquidity was underpriced previously, he said.

**Automated trading.** In November 2015, the CFTC proposed Regulation Automated Trading (AT), a set of rules that would impose risk controls and registration requirements in the area of automated trading. Some members were concerned that proposed registration and risk control requirements in Regulation AT could unduly restrict access to the markets. Jerry Jeske of the Commodity Market Council said the proposal threatens electronic access to the marketplace, not just for traders, but for end users.

However, Tom Coyle of the National Grain and Feed Association said that electronic order systems reduce the amount of information available because nobody knows who is trading. In the past, with manual order entry and the pit environment, market participants got an indication of who was trading the market. In the pit, if a trader didn't follow through on a bid, they would be shunned immediately. But today, he said, we don't see that information, and too often price movements appear random, which plays havoc on reliable risk management. He suggested considering implementing rules that require a minimum of two to three second duration for algorithmic trading orders, so that orders can't be pulled before they're executed.

But Kim Taylor of the CME Group cautioned against the idea of a minimum bid duration. "If you require people to put their market exposure out into the marketplace for some extended period of time, then what is likely to result is that there will be fewer people making wider markets and it could have a deleterious effect and availability of liquidity to the marketplace overall. There are two sides to the equation," she said.

Massad clarified that the aim of the proposed rules is to address operational risk and prevent market disruption, for example due to untested algorithms or technological failure, and the rules are not prescriptive. The CFTC is looking at risk controls that have been identified as best practices, "certainly not dictating how long people have to keep bids open or anything like that."

Massad added that the scope of who should be subject to the risk controls is a challenging issue, and that actually some electronic traders have said that the scope should be broader because they are more concerned about risks from small participants than large ones.

"I appreciate the difficulties of that and the risk that we don't want to overreach, and I don't want to impose excessive cost on the market. But we do, I think, need to address the risk that the high degree of automated trading in markets poses today," he said.

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