Tom Lehrkinder, Senior Analyst
April 2018

Selective RFQ: Voice Bridging E-Trading

Best of Both Worlds

The historical divide between all-to-all order books and voice- or chat-driven OTC trading is eroding, as market participants look to new and innovative models to harness the new trading infrastructure while still preserving the advantages of the traditional workflow in markets where liquidity is fragmented and challenged.

To this end, MiFID II has become the latest regulatory regime to act as a catalyst for change in increasingly automated fixed income and fixed income derivatives trading environments. The ability to preserve key elements of the OTC trading workflow while leveraging the benefits of electronic price formation is a key advantage for market participants looking to manage fixed income trading and exposure in the new world. Challenges around end-to-end compliance remain a primary consideration when weighing any change to the often manual and opaque fixed income markets.

TABB Group recently spoke with and surveyed market participants trading exchange-listed and OTC derivatives as well as cash securities. Our goal was to gather their feedback on voice-to-electronic trends, including potential solutions and their existing impressions of the innovative ***Selective RFQ*** approach.

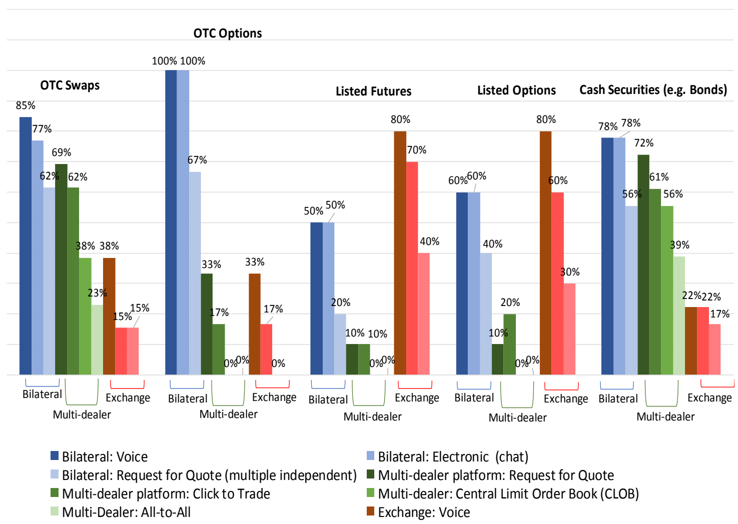
Why Selective RFQ?

Is it any wonder that market participants are increasingly looking at the huge market disruption caused by the new European regulatory framework and asking what tangible effect this will have on trading behavior? The US experience has already shown that a rising tide will lift all ships, and a much wider universe of products than those directly touched by the new rules will start to become more centralized and discoverable as time goes on. State-mandated regulations are poised to succeed where the market has consistently failed to lead and provide the impetus for a wholesale shift in the way global market participants assess and track their execution choices. In the first instance, this will largely benefit the new cornerstone of the evolving market structure: the exchanges and regulated venues that have long positioned themselves to benefit from this inevitable shift (*see Exhibit 1*).

Key Points

- OTC trading workflows are slowly changing with regulation helping push the envelope.
- Derivatives exchanges including Deutsche Borse's Eurex are willing partners for change and have provided venues such as Eurex EnLight to transact using a hybrid method.
- The Central Limit Order Book (CLOB) model is not the answer to all electronic trading solutions.
- Selective RFQ goes a long way to comply with the MiFID II requirements around best execution.
- The cost of compliance is easing, and the related resources are being redeployed to revenue-generating areas.

Exhibit 1: Execution Selection Choices by Asset Type (TABB Group Sample)



Source: TABB Group Survey Q1 2018

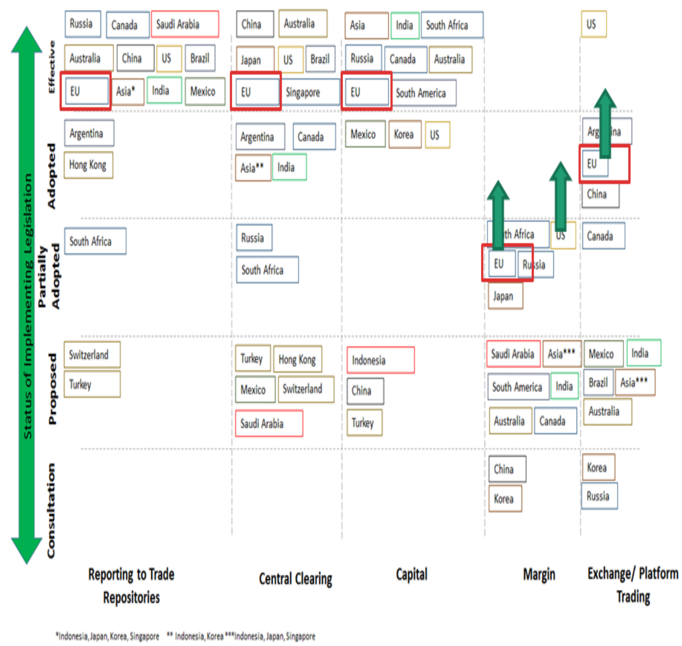
Most recently, the role of a fixed income derivatives trader has transformed, from picking up the phone and calling a dealer desk or a broker to becoming a master of multi-tasking across various trading modes and platforms. When TABB Group endeavored to explore the market structure supporting fixed income derivatives trading, we confirmed that, despite changes in regulation and improvements in electronic trading, there remains a proliferation of voice- and chat-based communications and execution. Exchanges have been actively developing alternatives to this workflow, taking the best components and translating them to the new compliance world – *Enter:* the Selective RFQ model. To understand how this model is a natural evolution of the marketplace, it is necessary to recognize the changing needs of market participants due to an evolving regulatory landscape.

Path to Compliance

The shift from voice to electronic, however, neither occurs simply or is affected quickly. Significant changes are needed to the trading infrastructure and interfaces available to end users, execution brokers and market makers to enact this change. Soaring technology, compliance, margin and clearing costs need to be much better understood by the market, and big data needs to be incorporated into and used alongside best execution analysis at investment firms. The onerous requirements for the provision of this in a timely manner sit with the execution brokers and sell-side participants, which are already under pressure to manage their compliance costs and restrict liability under the new rules.

Ever since the G20 commitment at Pittsburgh in 2009 to overhaul the derivatives market, there has been a global shift toward implementing regimes aimed at bolstering transparency and investor protection. While the US has led the way in general, with the implementation of mandatory trading for certain classes of swaps on swap execution facilities (SEFs) since October 2013, European rules are catching up (*see Exhibit 2*). As these are by far the two largest regions for global over-the-counter (OTC) and exchange trading, it is key to understand the dynamics that underpin these changes for both buy- and sell-side workflow and operating costs as we look to assess the trends that underpin trading behavior in the coming years.

Exhibit 2: Status of Global Derivatives Reforms: Europe and the US Are Coming into Alignment



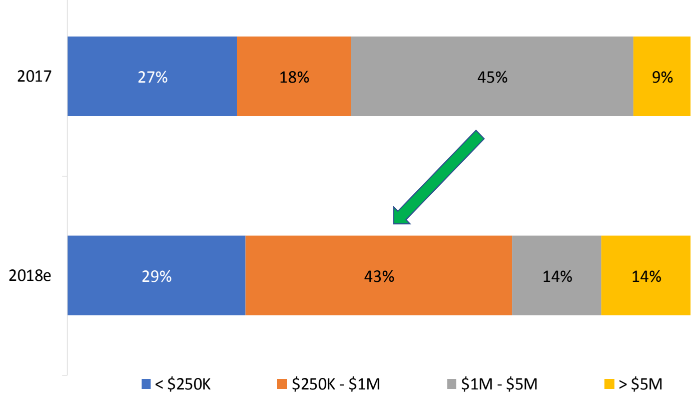
Source: FSB, TABB Group

The implementation of the European Markets in Financial Instruments Directive/Regulation (MiFID II/MiFIR) in January 2018 brought with it an incremental increase in connectivity, compliance and technology costs for fixed income market participants as they continue to update archaic market standards and workflows from the traditional fixed income and derivatives paradigms. In the OTC swaps market, the proliferation of platforms catering to different market participants (and the development of anonymous, all-to-all venues) has meant a marked change from predominantly bilateral and uncleared flows. This has also meant an increase in available connectivity, with the partial emergence of API connectivity and liquidity aggregators in the market.

Cost of Compliance

The good news is that most of the costs for MiFID II compliance related to best execution requirements are in the rear-view mirror (*see Exhibit 3, next page*).

Exhibit 3: Estimated Firm Costs, MiFID II Compliance, Best-Ex Requirements



Source: TABB Group Survey Q1 2018

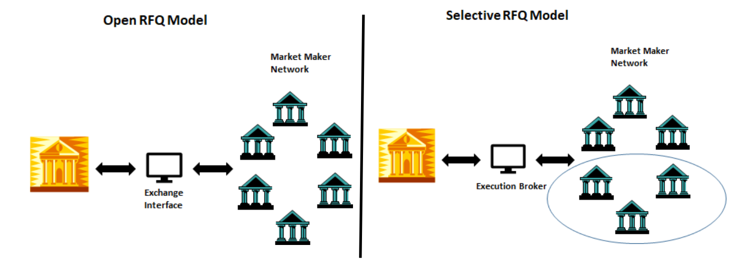
While there is a component around maintenance and improvements to the initial development, the heavy lift in spending is most noticeable as a 2017 event. Going forward, the maintenance factor will still be important, while resources are shifted to focus on other forms of technology and support that will help drive business and improve workflow.

One should also be aware of the importance of what has not happened post-financial crisis as much as what has. The way people have opted to continue trading even in the new environment gives a clear idea of the natural limits of market evolution in the fixed income world. The chosen methods of trading are as important as the venues, and the levels of automation and order book adoption have varied hugely, even as the world has moved toward an electronic and automated paradigm.

Innovative Solution: An On-Exchange RFQ Model

Much like the development of a dual model for analyzing the development of electronification in the OTC fixed income universe, if exchanges are to expand their trading models to capture the migration flow out of these markets, it will be necessary to adjust the workflow to fit the post-MiFID picture. To date, the majority of those voice trades executed by market makers are done "off-book." The off-book market in fixed income options has been the beneficiary of customization in much the same way as the swaps market, coming into its own where large size, long tenor and complicated exposures are being sought. A new Selective RFQ model has been developed that is designed for the opposite end of the spectrum (*see Exhibit 4*).

Exhibit 4: Open and Selective Exchange RFQ Models



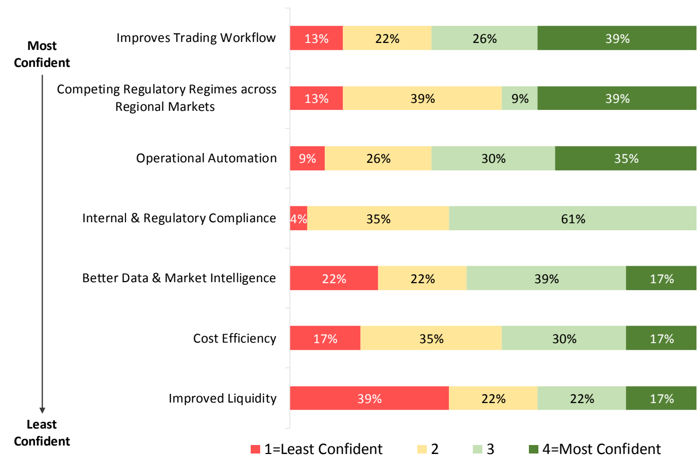
Source: TABB Group, SIFMA

In this disclosed paradigm, a session-based RFQ process is initiated by the execution broker, who can electronically select market makers through the exchange STP with the ability to adopt indicative or firm RFQ and alter price and size of trades during the session. This is tailormade for markets that are less liquid or have unique pockets of liquidity and is adaptable to strategy and block -size trades that can be managed over several orders during the session (working the order over time). A secondary benefit to this richer data source (higher hit rates and tradeable quotes) will be to help brokers and market makers access alternative data that can help the process of meeting the derivatives fairness test under Article 65.6. Engaging with electronic rather than voice execution on exchange platforms will enable MiFID compliance with both best execution and audit trail requirements in an integrated technology architecture that also manages down both the cost of trading and compliance, particularly when compared to the OTC markets. Market makers that typically engage with their exchanges through their independent software vendors will also increasingly be able to utilize RFQ functionality for their exchange trading books.

Migration to Electronic Trading

Further, TABB Group outreach indicates that market participants are becoming increasingly confident that further electronification of fixed income derivatives markets will stem from ancillary factors. Standardization of products and services in addition to improved automation will assist in having better ***trading workflows*** and decision-making capabilities (*see Exhibit 5, next page*).

Exhibit 5: Main Drivers for Electronic Adoption Across Fixed Income Derivatives



Source: TABB Group Survey Q1 2018

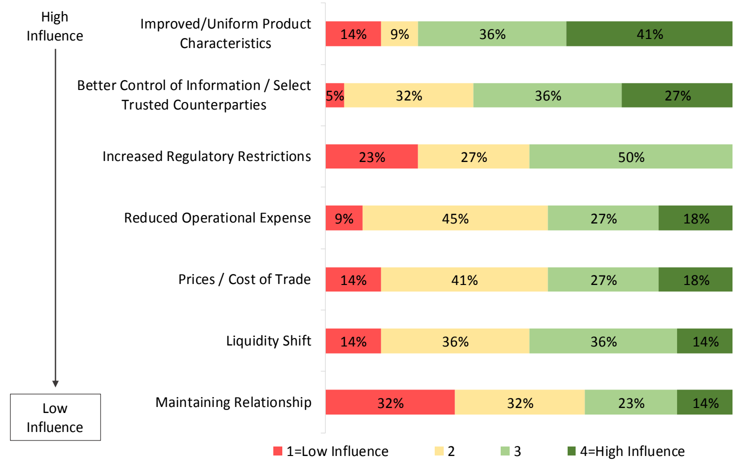
So, while global risk and compliance remain major factors to consider, the factor of competing regulatory regimes across regional markets is more top-of-mind. And while cost differences and assumed improved liquidity is a topic often discussed, the expectation of driving short-term change for electrifying markets is ranked considerably lower.

Fixed income traders agree that there are many drivers affecting the electronification of the fixed income derivatives markets, but interestingly, at the bottom of the list is ***improved liquidity.*** Unfortunately, the mentality remains that market structure is changing because of regulation and the need for more efficient workflow. If a new paradigm such as Selective RFQ can unlock access to improved liquidity, Eurex and other exchanges will have made a significant dent in the traditional OTC market.

The net effect of fixed income electronic trading and Selective RFQ will be to rid the "dinosaur trading mentality" and accelelerate the trend toward electronic adoption across fixed income markets. This will have a significant effect on the way people choose to trade, where they trade and with whom. Interestingly, this has been observable across the sprectrum of fixed income products and over the divide between exchange- and venue-based markets, evidenced by trader sentiment reported in our latest survey results.

Traders' historical habits and comfort zones are being challenged by process and regulation in terms of electronic adoption of new fixed income trading protocols. There is change underfoot for the traders and they realize that there are not enough reasons to hold onto the past. Traders who feel that ***maintaining relationships*** is low on the influence scale may have missed the subtlety that the "Selective" part of Selective RFQ does in fact involve relationships. It is not a faceless CLOB (*see Exhibit 6*).

Exhibit 6: Main Drivers of Wider Acceptance of RFQ Trading

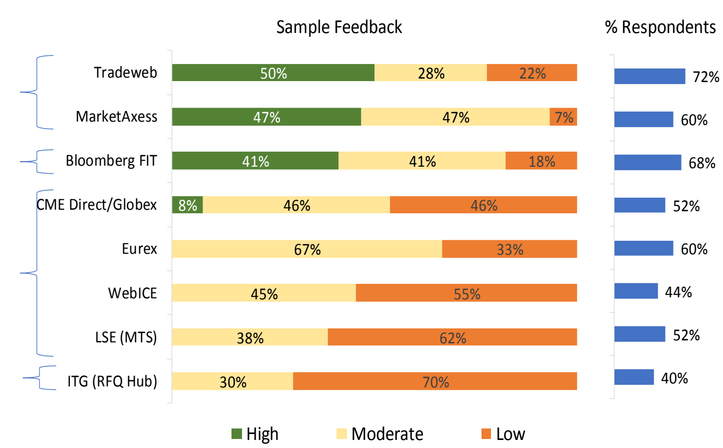


Source: TABB Group Survey Q1 2018

Selective RFQ Adoption

Familiarity with Selective RFQ models and RFQ venues is increasing. Venues such as Tradeweb and MarketAxess have a long head-start on the exchanges that now are looking to deploy a hybrid solution. For example, Eurex Exchange, owned by Deutsche Borse, in Europe has introduced **Eurex EnLight** – a product enabling RFQ and the capability to select counterparties with full control of information being shared. When market participants were asked about this product, which has only undergone a soft launch, results were generally favorable and indicative of the positive reinforcement expected in potential usage over time (*see Exhibit 7*).

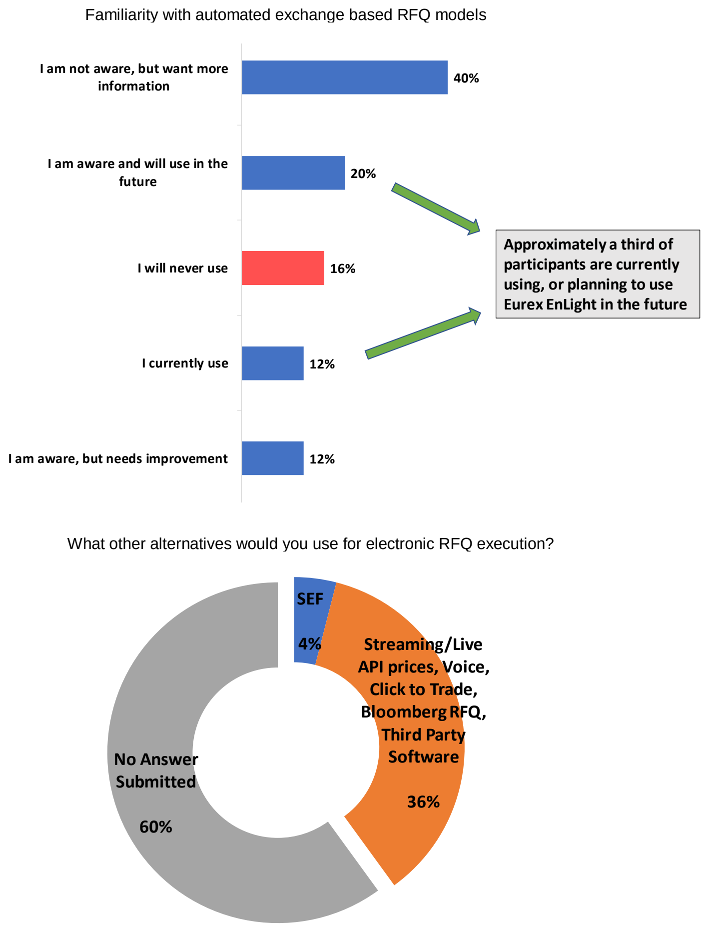
Exhibit 7: RFQ Venues in Terms of Attractiveness of Solution



Source: TABB Group Survey Q1 2018

At the same time, competitive solutions directly comparable to the Selective RFQ and the Eurex product are somewhat difficult to ascertain (*see Exhibit 8*).

Exhibits 8: RFQ and Potential Alternatives



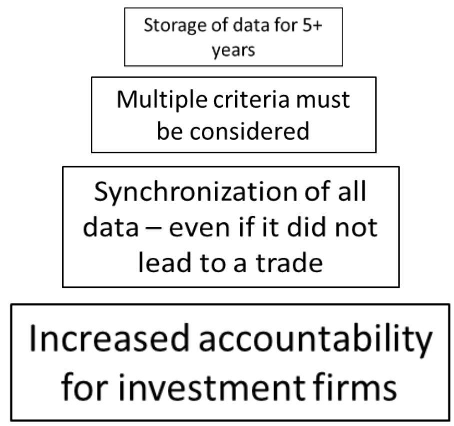
Source: TABB Group Survey Q1 2018

When asked specifically about alternatives to Eurex's EnLight platform, 60 percent did not have a qualified answer. Responses included concepts and solutions that were somewhat workarounds to the same idea. Evidently, the Selective RFQ solution is an innovative solution for a specific trading requirement.

Best Execution: Fit for Purpose?

MiFID II applies a higher legal standard to best execution than ever before, requiring firms to take "all sufficient steps" rather than "all reasonable steps" to complete client orders in the most effective way, based on factors such as the cost and speed of execution. This subtlty added a very large level of definitive responsibility and accountability to the executing firm and removed the interpretation of what would be loosely considereded reasonable. In addition, MiFID II extends the concept of best execution beyond equities to other asset classes. Fixed income derivatives will fall under this umbrella, and an exchage-based platform would cover most of the bases (*see Exhibit 9*).

Exhibit 9: Building Block of Best Execution



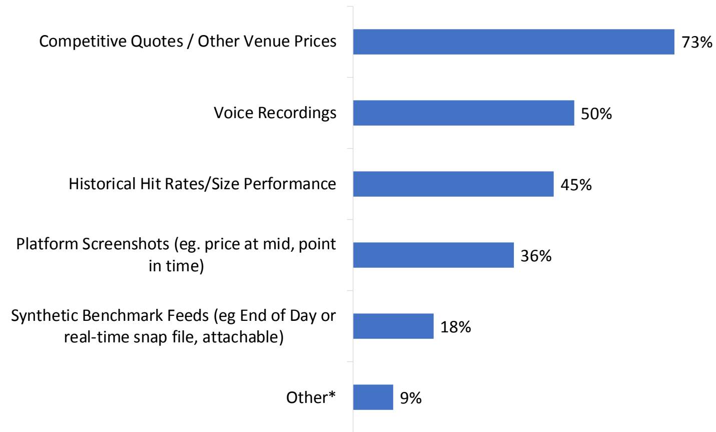
Source: TABB Group

Investment firms will be required to demonstrate how they have considered each of these factors in their best execution process and support their conclusions with quantitative analysis. Firms will be required to take into account the specific characteristics of each client to determine the relative importance of each factor.

MiFID II (Article 64) also introduces an additional fairness test for over-the-counter products, to ensure the price quoted to the client is fair, taking into account market data and the prices of similar products. This highlights the need to put more formal processes in place for best execution around OTC products and to integrate synthetic data feeds, and ESMA further requires systematic checks for conflicts of interest in those decisions.

At the heart of MiFID II's best execution rules are new data requirements on venues and trading firms that make it easier to measure execution quality. Trading venues and systematic internalisers will be required to publish on a quarterly basis data related to best execution, free of charge, including price information for each trading day, costs, speed, and likelihood of execution for individual financial instruments (see Exhibit 10). Furthermore, investment firms will be required to publish annual reports, across each asset class, ranking their top five trading venues when executing client orders, providing information on order flow and execution quality. This information must be published free of charge and in a machine-readable format.

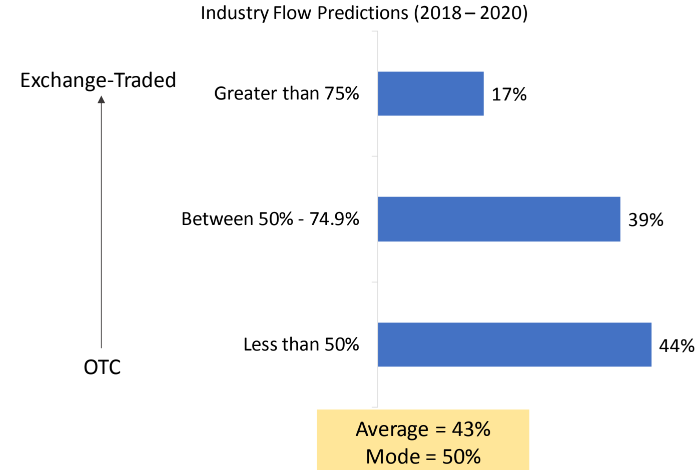
Exhibit 10: What Firms Expect to Include Under New European Best-Ex Policy



**Other = "All of the above" & "Fair Value Calculations based on Theoretical Values"*

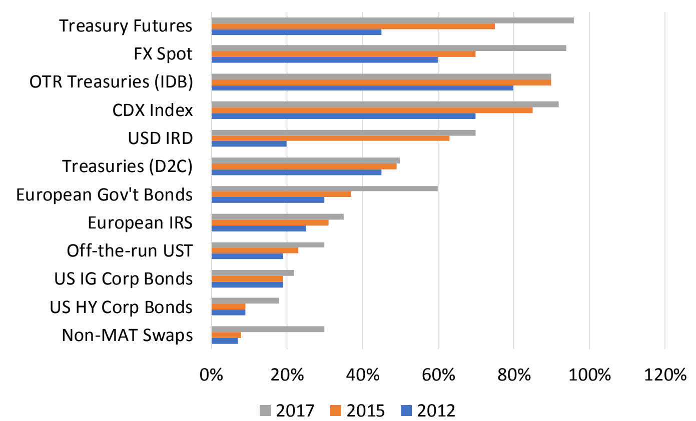
Source: TABB Group Survey Q1 2018

Exhibit 11: Estimated Industry Flow to Migrate from OTC into Exchange-Traded Products



Source: TABB Group Survey Q1 2018

Exhibit 12: Electronic Adoption in OTC Markets



Source: TABB Group, FIA

Reality Check: OTC to Exchange Migration

There has been an acceleration in the long-awaited migration out of OTC markets and venues, and we expect this trend to accelerate further as regulatory uncertainty and cross-border compliance weighs down swap flows, largely affecting the huge notional outstanding in the interest rate swap markets.

MiFID II will attempt to bring equities-like transparency to non-equity asset classes, including fixed income, derivatives and ETFs. In Europe, publishing ETF and fixed income trades never was a requirement and they were only previously reported to regulators. This new transparency is yet another exchange traded characteristic that the market will need to digest.

Fifty-six percent of derivatives traders TABB Group spoke with believe that more than 50% of OTC product flow will migrate to some form of an exchange-traded product over the next two years. This does not necessarily mean an immediate shift to a CLOB or central limit order book methodology; but certainly mechanisms such as a Selective RFQ can help bridge the gap from OTC to CLOB (*see Exhibit 11*).

The OTC and Listed Markets

It is difficult to overstate how important the implementation of the US Dodd-Frank rules has been to the development of electronic adoption across the entire fixed income universe. The proliferation of regulated electronic trading venues has led to a mushrooming of electronic markets well beyond the mandated trading product suite and into other areas (*see Exhibit 12*).

The highest rate of electronic adoption over the US implementation period is in non-Made Available to Trade (MAT) swaps, those that specifically lie outside the mandatory US regime. Those instruments are more than four times more likely to be executed electronically than would have been the case just before implementation of Dodd-Frank. This is followed by dollar-denominated interest rate swaps (having risen by nearly 50 percentage points to 70 percent of the market) and Treasury futures, which have predominantly traded electronically for years.

This shows through the very narrow lens of the US framework that efficiency within a recognized and pre-existing framework is very persuasive to market participants. However, there are significant roadblocks to the development of a fully order book-based model in the derivatives space. There is every indication that, beyond the basic shift with embedded solutions that accommodate voice to electronic, further innovation in the OTC space will have to adapt to trader workflow. This is where a Selective RFQ model makes sense.

Electronic solutions for fixed income derivatives are not likely to simply jump to the CLOB. There is a need to first replicate some of the key aspects of the existing voice/bilateral trading market-structure (e.g., non-anonymous to preserve relationships or the ability to control information flow toward single counterparties).

The listed market can be looked to as the poster child for electronification. Electronification in the exchange space is high, with 75 percent of UK and 80 percent of US options on futures executed electronically, according to TABB Group and industry estimates. This growth has been driven by an increase in the use of algos in the underlying futures market (currently estimated at 75 percent). Much like the OTC interest rate swap market, the market in equivalent listed derivatives has benefitted from regulatory headwinds, diversification and the need to manage margin and capital costs. Selective RFQ goes a long way in bridging the gap between voice and electronic execution.

Conclusion

The world did not stop on Jan. 2, 2018. MiFID II was rolled out with a practical attitude by the regulators in terms of expectations around full compliance. Trading continued into the new year as the global financial services industry made great strides adapting to a changing – and many would say (although begrudgingly), an improving – regulatory environment and expanding electronic trading world. Rather than trying to overhaul the entire traditional trading workflow in one fell swoop, the current theme is the need to preserve some elements of voice trading in OTC markets such as fixed income derivatives and translate them for the electronic trading model.

Selective RFQ is a prime example of merging the old and the new trading paradigms. Exchange-based venue solutions afford both the sell side and buy side the best opportunity to meet the best execution obligations as well as the challenge of committing capital on an automated basis. Given the heavy cost and compliance burden, pre-existing exchange and venue connectivity and infrastructure can be leveraged to ease the transition. Automation is increasing across an even wider spectrum of products across asset classes. Firms are demanding increased efficiencies and cost savings from straight-through processing (STP), and the exchange-based model fits the bill. Technology and human-aided market structure have advanced to the point where they can coexist without being jealous of each other. The gap between OTC and electronic trading continues to close and the immediate solution may allow for a healthy hybrid model such as Selective RFQ.

▲

