CLOB execution – the new norm?

The mandatory introduction of Swap Execution Facilities (SEFs) in the US in 2013 sparked a substantial shift in the structure and manner in which OTC derivatives were traded. Almost two years on, trading volumes on SEFs continue to grow substantially as compliance headaches subside. But now a new debate rages on: what is the most effective method of trade execution in such a diverse and complex market?

Prior to the 2008 financial crisis, OTC derivatives were traditionally voice-traded and somewhat opaque. New rules and regulations intended to drive many trades in the US onto regulated electronic venues offering greater transparency, efficiency and fairness.

The interest rate swaps (IRS) market has thrived in this new environment. Trading on SEFs averaged $347.4 billion per day in May 2015, a 40% increase compared to the same month last year, demonstrating their continued growth in volumes[1].

As the transition towards electronic trading of OTC instruments continues, participants have been increasingly focused on selecting the most appropriate method of trade execution. The Central Limit Order Book (CLOB) is at the focal point of this debate as it continues to gain traction as an alternative to the traditional Request-For-Quote (RFQ) approach. As a viable alternative to the relative opaqueness of a dealer-to-client quote based system, volumes have increased significantly.

Tradition, itself one of world's largest interdealer brokers, launched Trad-X in 2011 – a dedicated platform for OTC interest rate swaps trading – utilising a combination of electronic and hybrid CLOB execution methodology across multiple currencies. Since the introduction of SEFs into the US marketplace, Trad-X has formed the backbone of TraditionSEF's Interest Rate Swap Central Limit Order Book (CLOB) liquidity. In 2015, more than 94% of Tradition's "on-SEF" USD interest rate swap volumes were executed into the Trad-X central limit order book – highlighting the growing popularity of the model in the market.

CLOB: the future of buy-side execution?

Today, both RFQ and CLOB execution have a role to play in derivatives trading, enabling participants to select an appropriate, or preferred, method based on the counterparty, instrument, size, market conditions and bespoke nature of the trade.

CLOB trading has been recognised as helping to facilitate a level playing field and open-access between the order originator and the market makers, with better price discovery and pre-execution anonymity. A CLOB participant has the ability to either aggress on prices across a narrow bid-offer spread, or submit a passive order at the price and size they wish to execute to the Order Book for all participants to see.

In the case of Trad-X, the flexibility of executing in this way is assisted by multiple order types such as Immediate or Cancel (IOC) or utilisation of Iceberg Orders. The constant flow of two-way prices from market makers and interaction by voice brokers, who augment the electronic liquidity through voice-volunteered orders, ensures a dynamic ecology. Furthermore as every bid or offer is submitted into the CLOB, it ensures the primacy for the screen and complete fair and equal access for all participants.

Trad-X's CLOB receives two-way prices on a continuous basis from at least 13 banks across all liquid tenors, with irrefutable electronic pricing that is fully tradeable. This electronic model has been adopted by the International Swaps and Derivatives Association (ISDA) and removes any guesswork – offering accurate pricing, clear spreads and depth of liquidity on either side of the mid. Having this reliability allows the CLOB to provide this pricing onto its reference screens used by issuers and their syndicate managers – helping to facilitate best execution.

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[1] *FIA SEF Tracker, Issue 14, January 2014 - May 2015*

RFQ also plays a key role in the market today, enabling participants to receive bespoke pricing aligned to individual trading strategies and positions from a trusted network of counterparties. However, while tighter spreads streamed from multiple liquidity providers and best execution analysis tools have convinced some buy-side firm to migrate to CLOBs, there has been an overall reluctance to move away from the traditional RFQ model.

RFQ arguably comes at a price. Last look functionality, for example, enables the quote issuer to retract or even change a price before execution – often to the detriment of the end user. Furthermore, buy-side members that request quotes from a variety of dealers are forced to show their hand, sacrificing their anonymity and even the side and size of the trade they wish to place. In comparison, participants trading on a CLOB only renounce their anonymity when a trade occurs, rather than when the price is requested. But perhaps most importantly, the willingness to respond to a price request depends on each institution and pricing provided by respondents; equal treatment cannot be guaranteed.

As a result, regulatory bodies such as the U.S. Commodity Futures Trading Commission (CFTC) have wholeheartedly supported a CLOB-based marketplace because of the improved level of transparency and fairness it provides.

As the buy-side look for new ways to access liquidity on SEFs, the compass is slowly being swayed towards CLOBs in the search for best execution. The protocol, which offers end-users a number of benefits, has already played a core role in how markets evolve. While take-up challenges remain, CLOB trading is increasingly gaining momentum from a broad section of the market, and the signs are pointing to increased adoption over the coming years.

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