

SURFACEExchange offers solution to FX option expiry concerns under Dodd-Frank

By HAMISH RISK
Published: 21 October 2011

PRINT | EMAIL

Tweet +1 in Share

SURFACEExchange, the US-based multi-dealer option trading platform, is offering a service that could streamline FX option exercises on expiry dates and alleviate the expiry concerns raised when new Dodd-Frank regulations come into effect in the FX derivatives markets in 2012.

Since FX options were mandated by regulators to be processed through clearing houses and traded on multi-dealer platforms – known as swap execution facilities – banks and clearing houses have been grappling with how to resolve two key issues.

Firstly, whether CLS would take clearing houses settlement risk when options were exercised and, secondly, how could option exercises be processed efficiently through clearing houses when they are traded across a multitude of trading platforms.

In the first instance, the industry hasn't resolved the guarantee of principal for clearing houses which has stalled progress in CCP implementation, while in the second instance, clearing houses have abdicated responsibility to the counterparties of option contracts to exercise bi-laterally, and then notify the clearing houses on the same day.

The manual exercise process is too clunky for the new era of electronic trading and has kept many players away from the market and has forced existing market participants to trade with a small number of counterparties in large notional amounts, says Evgeni Mitkov, SURFACEExchange's chief executive officer, in an interview with EuromoneyFXNews.

"SURFACEExchange has committed to making the FX option exercise process easier, so that anyone can trade the instrument, and they don't need a trading desk of 10 people to trade in this market," says Mitkov.

He founded SURFACE in the spring of 2009 and is the major shareholder. He then sought further investment, to build the platform, from a Belgian shipping company family office, which is now the firm's second-biggest shareholder. A 14-year veteran of the FX options market, he spent seven years at GFI prior to founding SURFACE.



"We would be more than happy to facilitate expiration for everybody. If you didn't do your trades with us, then we could get an upload and get them exercised on our platform. We have the technology to do that." Evgeni Mitkov

For more than a decade, Mitkov's vision was to help create an open, efficient, global FX derivatives market place. However, without market providers stepping in to smooth some of the bumps in the regulatory road, it could be at risk, he claims.

Smaller participants are placed at a distinct disadvantage, because of differences in how they access spot markets when they offset option exercises. These are largely determined by the credit quality of the counterparty or access to different pools of liquidity. For instance, a small regional bank in Germany might not have the same market access to the best bid and offer in the market than say a member of the primary market, EBS.

Additionally, the hard time-cut and thousands of strikes in most currency pairs create plenty of pin strike risk, forcing market participants to make split market decisions seconds before cut time. Mitkov says it's not unusual for 100 strikes to become in-the-money in the last five minutes before New York cut time.

As a result, there is no market standard in the FX market in establishing what the rate should be at the expiry in each currency pair, across one or two cuts daily, which makes it impossible for clearing houses to auto exercise options.

The exchange traded equity option model isn't likely to be replicated in the FX market. For example, US equity exchanges operate what is called NBBO – National Best Bid and Offer – so across the board at a particular millisecond, there's an NBBO in the entire equity market. Furthermore, option exercises happen on a Saturday, giving exchanges ample time to exercise options at a leisurely pace.

"You have to have some methodology that does it very fast, does it across different platforms," says Mitkov. "But even then, if you get exercised at that rate, and you don't have access to that market, you could lose a couple of pips here or there, and you're going to be out of pocket. You're running a lot of basis risk."

As a result, under the status quo, a counterparty might exercise an option differently because of that fact by deciding to exercise an out-the-money option or possibly not exercising an in-the-money option. This decision is often made one second before cut time, leaving the option buyer with one second to get the notice to the option seller.

That's further compounded by network traffic, and the speed of light limitations that make option exercises across continents a very challenging and daunting task, where, according to e-commerce experts, one could have at best a 200 millisecond connection, or as much as half a second on regular connection.

"We clearly are of the opinion that no clearing house has the technology to facilitate expirations and none of them is looking to stick its neck into that," says Mitkov. "We would be more than happy to facilitate expiration for everybody. If you didn't do your trades with us, then we could get an upload and get them exercised on our platform – we have the technology to do that."

SURFACE has invested in substantial bandwidth in preparation for the new trading regime under Dodd-Frank. Whereas most platforms run off a single box, with plenty of processing power, SURFACE operates a server farm using cloud computing, distributing the load across multiple servers.

"It probably wasn't necessary from day one, but we felt we had to be prepared for high-frequency trading before anyone else was, because you never know when that is going to hit you," says Mitkov. "Even more important than that were expirations. We cannot afford to die right at or before expirations, so we've put a lot of effort to try to make our platform as resilient as possible with current technology."

He adds that no other provider can offer such a solution. Providers running a request-for-quote model step out of the trade cycle as soon as the trade is matched. Counterparties know each other and handle everything else, including exercise.

"We stick our neck right up until expiration," says Mitkov. "We could deliver the spot tickets to both parties and they have to settle them."

He also adds that the expiration process is run by SURFACE, and the central prime broker, Citi, only gets involved in the settlement of spot tickets during the post-trade process. This has made Citi and the other prime brokers on the platform very comfortable, as they do not have to face the pin risk and make decisions on behalf of clients.

As a result, SURFACE will easily adapt to the central clearing model, and also make the life of the clearing house easier.

"I doubt any clearing house will want to be in the business of handling notices in the millisecond space to address the FX option exercise reality," Mitkov concludes.

As for the issue of guaranteeing of the exchange of principal, privately, prime brokers and option traders tell EuromoneyFXNews that implementation of clearing is being delayed until a compromise can be found between the clearing houses and the banks that own and operate CLS, which guarantees trade settlement for the industry.

The banks are believed to have come up with some proposals, although the Fed does not like them, one FX head tells EuromoneyFXNews. It is believed there have been two possible solutions pitched to the Fed.

"Basically, the Fed would not let CLS take clearing house settlement risk to keep it as a trump card, to make the banks work harder in proposing a really good clearing solution," says one market observer with knowledge of the negotiations.



MOST READ | MOST EMAILED

- 1 EuromoneyFXNews buyside e-trading survey
- 2 Euromoney FX survey 2011: Banks take fight to the algo traders
- 3 Business as usual for UBS in FX
- 4 Euromoney FX survey 2011: Nomura wins most improved market share
- 5 Euromoney FX survey 2011: Gold evolves as a currency