

mind your sef ... or not

Nodal Exchange CEO Paul Cusenza has been loosely holding two triggers for nearly two years: One is connected to a (proposed) SEF and the other is connected to the short end of a DCM. Either strategy has its pros and cons; unfortunately for him, one of his two primary options isn't yet fully known and probably won't be for several months. Remember that Nodal Exchange is largely considered to be a critical electronic market for North American power. If you trade basis power – and most of you do – Nodal is about the only game in town. So, if Nodal is left hanging, where does that leave everybody else? Read on.

Somehow, through it all, Cusenza remains somewhat nonplussed by the whole CFTC exchange rules process. He foresees the balance of Dodd-Frank being fully resolved in 2013 – SEF rules, limits, Core Principle 9 and so on. “So 2014 will really be all about implementation and adjusting to new market rules ...” Cusenza says.

Since mid-October, Nodal has been in the throes of the DCM registration process. Nodal had been operating as a futures trading ECM for many years, but as Cusenza tells it, the exchange had always planned to formally pull the trigger and become a DCM. Under Dodd-Frank, ECMs have basically gone away, but are allowed to operate in concept, exempted so to speak, until all these other entity rules are known. Technically, companies don't have to register as a SEF, for example, until 60 days following the final SEF rule. Commissioner Jill Sommers told us in an interview this week that the SEF rule will likely be voted out some time in late Q1. Commissioner Scott O'Malia and Commissioner Bart Chilton made similar statements to us in recent

days. So, for operations like Nodal, the current options are few. It could continue with the DCM designation process and operate as quasi-ECM while it waits to see what the final SEF rules say. Got that?

Following the market's monumental and arguably unforeseen shift to futures on Oct. 12, customers suddenly raised questions, Cusenza tells us, about “what they should be calling certain contracts on the Nodal screens.”

“As a result of that chaos, we made the decision there and then to fully pursue the DCM status ... at the time, however, we had no idea that no-action letters were coming and that deadlines would be extended in any case. So, that's what we did, and we're awaiting certification now. We would have liked to delay that decision, hoping to have achieved a bit more scale, but considering all the confusion in the market at the time relating to swaps, we had to make a decision.”

Of course, SEFs will still serve a purpose in the marketplace, regulators tell us, though how many will register and to what end is anybody's guess. ICE went the DCM route, but they still largely plan to register a SEF entity of some flavor to manage bilateral, noncleared trades as they always have. CME may launch a SEF for the same reason. Nodal may not follow suit, however, Cusenza says, particularly if the 85 percent rule inside Core Principle 9 doesn't go away. Why does this matter so much to Nodal? Because Nodal offers about 1,800 locational contracts -- cleared power basis contracts – and go figure, not all of them are robustly liquid. If the 85 percent rule moves forward, a large chunk of these contracts would not make the cut, which would be a huge problem for utility hedgers in the enormously complex power markets. These less liquid contracts would eventually be forced to move over to

Swapland. Call this another unintended consequence of overcomplicated, piecemeal regulation.

Fortunately, many folks we talk to suggest the 85 percent rule will eventually be DOA once the so-called Transparency Suite is voted on. The same commissioners we've asked about the rule's timing have also said that the percentage number may be closer to 30 percent. Or, it may be nil. Fortunately for Cusenza, Nodal is in good company on the so-called 85 percent rule. Once ICE veered away from the SEF track in mid-2012, it essentially put Nodal in the same DCM camp as CME and ICE, and thus, it had powerful allies pushing to do away with the rule for listed contracts. Cusenza says that a set, across-the-board percentage for all contracts doesn't make a lot of sense. “I think it should be up to the customer whether they block trade or go to a central limit order book ... you know the legislation actually says this. We (at Nodal) fail to see the value in setting an 85 percent level, or any level for that matter. Systemic risk isn't threatened if we don't have a set percentage.”

We tend to agree. Market participants tell us that the power markets are a less risky place to be these days, thanks to the hedging opportunities available through the Nodal platform. He says that Nodal represents just shy of 20 percent of total cleared open interest for power futures in North America, up from 10 percent a year ago.

He says that brokers can take some of the credit for that growth. Unlike the current direction of market rules, which seem to be skewed against the voice sector, Cusenza welcomes broker participation in all his markets. “Today, as an ECM, voice brokers have been an important dimension in our auction, but we also get a lot of support over-the-counter from voice brokers. We encourage this. Going forward, we want to continue to support this relationship any way we can. Here's another reason why Core Principle 9 is so important and why it should not be limited. We're not quite sure who it's helping to be so limited. By releasing this restriction, it would mean that voice firms will continue to operate,” he says. “And we support this fully.”

Cusenza is CEO of the Nodal Exchange. Go to www.nodalexchange.com