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Using Pre-Execution Communications to Improve Dairy Market Liquidity - July 2015

Dairy futures and options markets in the U.S. have evolved since the early 1990's. Trading volume and market liquidity has increased as have the number of products to where the CME Group offers a suite of dairy products – class 3 milk, class 4 milk, cheese, dry whey, butter, and NFDM. In the last 2 years, market activity has improved to the point where all dairy products are relatively more liquid than they were in the past 20+ years. However, some market participants still have difficulty executing larger orders or at times when trading volume is lower.

One solution to this problem is for market participants to engage in pre-execution communications with other market participants. This is a quick and easy way to find liquidity in the market and execute trades at times when liquidity is not evident. One party might not want to enter a large order over concern of how it could impact the market. At times, there are other parties with opposite positions that may have the same concern and also are not entering their order. In short, pre-execution communications can help you try to find someone to take the opposite side of your trade.

Background on Pre-Execution Communications

Anyone can participate in pre-execution (pre-ex) communications, but they are underutilized as many people either don't know about them or don't know how they work. In fact, it is quite simple. Pre-ex communications can occur between market participants for the purpose of discerning interest in the execution of a trade prior to exposing the order to the market. This can be used for executing a trade in an individual month or a strip of multiple months. The confidential communication can take place using a variety of methods (e.g. email, text message, phone) and involves discussion of the size, side of market, or price of an order. Importantly, these communications are for transactions executed electronically using Globex. To execute the transaction, the party that initiated the communication is required to enter it into Globex. After the order is entered, at least 5 seconds must elapse before the opposing order can be entered. After the 5 seconds have elapsed, and the order is still active, the opposite side of the transaction enters their order and the trade is completed. However, there is no guarantee the intended counter-party will be able to take the opposite side of the transaction as the order is live in the market and anyone is able to execute against it. This may or may not matter to the two parties, but needs to be understood before entering the order.

The pre-execution communication process for options requires a few additional steps. The pre-execution communication takes place the same as for futures. However, a Request for Quote (RFQ) is first entered into Globex via a Globex Cross. Then a Request for Cross (RFC), an order that includes both the buy and sell orders arising from the pre-execution communication, is entered no less than 15 seconds and no more than 30 seconds after the entry of the RFQ. If the RFC is not entered within 30 seconds after the RFQ, a new RFQ will need to be entered.

Examples from Practitioner's Point of View

You have a large order to execute, but the market liquidity cannot handle the order without moving the market. Most people will just place the order with a broker or enter it online, but only execute in small amounts. This could take time and may only get partially executed, or maybe not at all. By using pre-execution communications, you can identify market liquidity and execute your trades in a short period of time without impacting the market.

Using NFDM (nonfat dry milk) futures as an example, you are an end-user of NFDM and want to buy 100 contracts per month from July to December at current prices to cover your price risk during that time period. However, in recent days, only 5-10 contracts per month have been trading. Obviously, a buy order of 100 contracts per month would be disruptive and likely cause prices to rally beyond your price target. So, you contact parties that might have an interest in taking the opposite side of your transaction. These parties could be brokerage firms, physical product traders, speculators, manufacturers, or other companies involved in dairy trading. In your communication, you note your interest in buying 100 NFDM futures contracts in July-December at current price levels. A large trader of physical NFDM expresses interest in selling 100 NFDM contracts for the same time period in between the best bid and offer prices. After confirming the details and the intended time of the transaction, you enter each individual month's order into Globex just as you normally would any other transaction. The seller, in this case, sees the buy orders appear on the Globex system, and after waiting 5 or more seconds, enters sell orders in the same amounts. Within a short period of time, you have bought 600 NFDM futures contracts for July-December coverage. After execution, all other aspects of the futures transaction are the same as any other trade.

For an example using options, a foodservice company wants to lock-in a range for their cheese costs for Q3 at current price levels. They don't want to pay more than $2.00/lb and don't believe prices will be below $1.75. So, they want to buy $2.00 calls and sell $1.75 puts at current option premiums. On average, they use 2 million pounds of cheese per month or 100 contracts per month. The foodservice company, or more likely their broker, contacts a number of potential counter-parties to determine if they have interest in taking the opposite side of this option transaction. A speculator agrees to sell 100 $2.00 calls and buy $1.75 puts for each month at current premiums. Before the transaction is executed, the foodservice company or their broker first enters a RFQ into Globex and then a RFC is entered into Globex at least 15 seconds after the RFQ was entered, but not more than 30 seconds. An RFC is a two-sided order ticket that has the buy and sell side information - this is why it is typically entered by a broker rather than two direct counterparties. The RFC submits both the buy and sell side at the same time. Provided the price is in between the best bid and offer in the market, the two sides will match. There is no need for the other counterparty to wait to meet in the order book when an RFC has been submitted. If the price is not in between the best bid and offer in the market, then the order could match against existing orders in the order book first. Like futures, once completed, all other aspects of the options transaction are the same as any other trade.

Key Points

- Pre-execution communications can be used by market participants to execute trades when market liquidity is not evident
- Interested parties are contacted to determine interest in taking the opposite side of a trade and given information on the price, volume, and time period
- If a counter-party is identified for a futures trade, the party that initiated the communication enters the trade into Globex. After 5 seconds, the counter-party can enter their side of the trade.
- Other than the pre-execution communication process, all other aspects of futures and options trades are the same if executed without the pre-execution communication

Frequently Asked Questions

Can pre-ex discussions be used for both electronic and pit transactions?

No – pre-ex discussions are only for trades executed electronically

Can pre-ex discussions be used to execute futures strips (multiple months)?

Yes – pre-ex discussions can be used for executing both individual months as well as strips

Is asking for a two-sided market (bid and offer) pre-ex communication?

No – pre-ex communication involves the discussion of size, side of the market, or the price of an order or potentially forthcoming order.

Is a discussion about an order that is already public knowledge (i.e. in the order book already) considered pre-ex?

No – it is already public knowledge

Are there special records keeping requirements if pre-ex communications are conducted?

No – the same recordkeeping requirements are in place for pre-ex as for all other Globex transactions

What happens if someone is contacted in a pre-ex communication about a trade, but does not want to participate?

They must not use any information learned to take advantage of the market. However, normal course of business can continue.

If pre-ex communication is used, who is responsible to ensure that at least 5 seconds has elapsed before executing a futures trade?

The person executing the order is responsible for waiting at least 5 seconds. If a broker is used, it is the broker's responsibility. If the person is executing the trade directly, then the individual is responsible.

If a broker is used to execute a trade using pre-ex communication, do they need permission from the customer?

Yes – the broker must have permission to work the order using pre-ex communication. The exchange does not specify how that permission is provided, but the broker needs to be able to show that permission was granted.

Do brokers usually execute options pre-ex trades?

Yes – typically, a broker will execute an options pre-ex trade because the RFC (Request for Cross) is two-sided, which means that whoever is entering the details of the trade has to have both parties' account information and permission to enter orders.

References

For more information, the CME Group issued a Market Regulation Advisory Notice on Pre-Execution Communications, which can be found at http://www.cmegroup.com/rulebook/rulebook-harmonization.html.

For dairy specifically, the CME Group has developed a Contact Directory for firms that have agreed to accept pre-execution communications. The Directory can be found at http://www.cmegroup.com/trading/agricultural/files/dairy-contact-directory.pdf.

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