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- 1. CESR Consultation on standardisation and exchange trading of OTC derivatives (CESR/10-610)**
- 2. CESR Consultation on Transaction Reporting on OTC Derivatives and Extension of the Scope of Transaction Reporting Obligations (CESR/10-809)**

Dear Mr. Comporti,

In response to the above mentioned consultation, please find below BVI¹ views on the subject at hand.

1. CESR Consultation on standardisation and exchange trading of OTC derivatives

a) General remarks

BVI in principle supports the aim of the EU Commission and the G 20 that all standardised OTC contracts should be traded on exchanges or electronic platforms, where appropriate. BVI fosters CESR's idea that greater standardisation of OTC contracts will improve efficiency in the derivatives markets. BVI believes that moving more (ISDA and national master agreements based) standardised derivative instruments from OTC trading to

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¹ BVI Bundesverband Investment and Asset Management e.V. represents the interests of the German investment fund and asset management industry. Its 84 members currently manage assets in excess of € 1.7 trillion, both in mutual funds and mandates. BVI's ID number in the EU register of interest representatives is 1575282143-01. For more information, please visit www.bvi.de.

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trading on organised markets will advance the level of transparency, enhance liquidity, and ensure efficiency and risk reduction in the derivative markets. Exchange trading should only be made mandatory if such trading helps increase liquidity and after having giving due regards to the benefits of increased use of electronic confirmation, clearing and trade reporting. Implementation of OTC derivatives exchange trading requirements needs careful planning also by the buy-side and should not be rushed. All market participants need sufficient time to prepare for the change.

BVI believes that in the foreseeable future not all OTC derivatives are sufficiently standardised, or fit for trading on exchanges and organised markets, e.g. because of low volume. The buy-side– both financial and non-financial firms (e.g. corporate end users) – need to retain the flexibility to conclude bi-lateral and non-standardised contracts to cover specific user needs.

b) Questions

Q1: Do you agree with CESR's assessment of the degree of standardisation of OTC derivatives? Is there any other element that CESR should take into account?

BVI supports CESR principles of contract standardisation, including corporate actions, as stated in para 13. Standardisation could result in liquid and transparent trading in the appropriate products with shrinking bid/offer spreads due to increased competition by the sell-side and the market makers. On the other hand, there should be no limitation to tailor-made derivative products. Thus, the end investor could benefit from better results.

Standardisation may be hindered by product and user requirements. With regard to interest rate products, due to a wide range of market participants (e.g. banks, asset managers, pension funds, corporations) the variety of OTC derivatives is very broad which makes it difficult to find a common standard. For example, certain investors would like to post potential margin requirements in bonds or stocks instead of cash which complicates the application of a common standard. The implementation of full legal conformity might be difficult due to well entrenched but different standards (e.g. ISDA v. national master agreement). Also, insurance derivatives may not yield themselves for standardisation as they require a different valuation treatment. Where there is a liquid market for the underlying asset, such as



equity, mark-to market can be applied easily. In insurance derivatives, there may not be a liquid market for the underlying asset. Therefore, other valuation methods, e.g. mark-to-model, should be permissible. Furthermore, due to regulatory restriction certain investors, including e.g. insurance companies, may use derivatives for hedging only. Risks in the markets, however, would increase if the overall use of other than hedging transactions would be severely restricted by regulation.

BVI acknowledges the strong contribution of ISDA to standardised derivative contract documentation. However, legal contract standardisation may not be based on ISDA master agreements only. The usage of country-specific master agreements is particularly necessary in the context of buy-side access to a CCP. A CCP should therefore not limit itself to a specific master agreement. National master agreements backed by high market acceptance such as the German Master Agreement (“Deutscher Rahmenvertrag”) must be acceptable in addition to ISDA documentation. The German master agreement is better adapted to the specific legal structure of German investment funds (contractual-type “Sondervermögen”) and similar funds existing in other markets such as Luxembourg (fonds communs de placement).

The use of both ISDA and national master contracts is possible. The ISDA Product Annexes may be applicable also under a national master agreement. Using the ISDA Product Annexes within the German master agreement needs some reconciliation in legal terms with respect to the applicable master agreement in order to avoid different interpretations between the contracting parties.

Finally, we would like to mention that ISDA does not cover all derivative contracts. For example, the 2005 ISDA Commodity Derivatives definitions focus on commodities only and do not include OTC contracts on a commodity index. Therefore, we do not agree with your assessment that the degree of standardisation of commodity derivatives transactions may be considered as “reasonable” (Para 19). Our members use German master agreement with respect to commodity indices and basket transactions as the ISDA Commodity Definitions are less specific. Commodity derivatives are used in complex structures, e.g. Asian rainbow options on commodity index baskets. Such derivative structures can hardly be considered as a standardised transaction.



Q2: Do you agree with the benefits and limitations of standardisation noted above? Please specify. Can you also describe and where possible quantify the potential impact of the limitations to standardisation? Are there any other elements that should be considered?

BVI supports CESR's assessment of the benefits and limitations deriving from standardisation of OTC contracts. Barriers to contract standardisation may result from accounting needs, e.g. adherence to hedge accounting, variable annuity hedging, or industry needs, e.g. raw material and input cost hedges by commodity producers and consumers.

Limited standardisation hinders access to a CCP. Contract standardisation is a prerequisite for being able to clear OTC contracts via a CCP. Today our members are not able to meet the CCP participation requirements because operational and legal barriers to investment fund CCP access are not satisfactorily solved. For example, standardised ISDA CDS contracts currently do not take into account the inability of UCIS to receive loans in case of a credit event. As a result UCITS participation in CDS CCP clearing is limited.

Specifically with regard to equity transactions, uniformity in settlement dates could lead to heavy market distortion if settlements in all OTC derivatives take place on the same day in a month. There are already now observable extreme market movements on dates when listed equity index futures, equity index options, single stock futures and single stock options all mature on the same day. Instead standardisation based on the time to maturity (e.g. 30, 90 days) is preferred.

With respect to FX- derivative trades some market participants believe that short dated FX forwards (less than 1 week) and hedging transactions should be out of the scope of standardization as well as long dated FX forwards (more than 1 year) where CCP do not support a broad range of collateral for margin handling.

Q3: Do you agree that greater standardisation is desirable? What should the goal of standardisation be?

BVI believes that well functioning derivative markets should be able to remain liquid through periods of stress. Greater standardisation is desirable to the extent market liquidity is enhanced and counterparty and operational risk is reduced, especially if trades can be confirmed on a t+0 basis.



Standardisation needs to encompass not only local needs but needs to cater to the cross border users requirements too, e.g. in the legal area.

BVI believes that in spite of all standardisation efforts there will remain the need for some derivative contracts which are tailored to specific needs and that such OTC derivatives cannot be standardised. BVI believes that the *bona fide* use of such non-standardised OTC transactions should not be restricted by e.g. additional capital requirements.

Q4: How can the industry and regulators continue to work together to build on existing initiatives and accelerate their impact?

BVI believes that legal, process and product standardisation should be subject to an organised process combining industry's and regulators' efforts. Industry expert groups/consultative bodies at EU level should be involved regularly in the process. There needs to be public consultation and surveys as well as strong involvement of buy-side representatives in the decision making process.

While industry experts will be well equipped to come up with legal process and product standards which are based on true market needs, regulators could guide the overall standard setting process, set the required timetable, and enact missing regulation where necessary. For example, the regulators could direct the market place to identify firstly the necessary legal, product and process standards for specific derivative product classes and secondly direct the industry to develop new standards where there a gaps to be filled. After the period of standard development regulation is most important in insuring adherence to the industry set standards by all market participants after the agreed implementation dates.

In spite of standardisation of certain products market participants will continue having good reasons for using bespoke OTC contracts rather than standardised derivatives. The regulators should not unduly discriminate such contracts, and e.g. allow participants to collateralise the transactions as an alternative to mandatory CCP clearing.

Q5: Are there any obstacles to standardisation that could be removed by regulatory action? Please elaborate.

Derivative product standardisation is quite often driven by the sell-side (e.g. brokers and investment banks). The buy-side should be more involved in the



process of e.g. contract standardisation. Regulators could help to encourage proper and fair representation of all market participants in the industry standard setting organisations and processes. Also standardisation should not lead to undue benefits to certain market participants, e.g. broker trades for own account should not be exempted from standards.

Equity funds are currently only allowed to post margin requirements in cash or in stock. Equity funds cannot post bonds as margins as these instruments are not an unrestricted eligible asset class. Therefore, the scope of accepting eligible collaterals should be extended to stocks (e.g. to blue chips). The same idea applies vice versa with respect to (corporate) bond funds which may not hold unrestricted government bonds as collateral.

Q6: Should regulators prioritise focus on a) a certain element of standardisation and/or b) a certain asset class? Please provide supporting rationale.

BVI thinks that the regulators should focus on a certain element of standardisation and a certain asset class.

Regulators should focus on certain elements of standardisation across asset classes, especially those relating to legal or process uniformity. With respect to element standardisation we suggest regulators to insist on adherence to ISO reference data standards for the identification of parties, transactions, ad accounts, in particular the BIC and ISIN codes.

A prioritisation of asset classes to be standardised should focus of the instruments which are most important to the stability and the functioning of the financial markets, mainly CDS, Fixed Income and Foreign Exchange.

Q7: CESR is exploring recommending to the European Commission the mandatory use of electronic confirmation systems. What are the one-off and ongoing costs of such a proposal? Please quantify your cost estimate.

BVI supports the aim to require the use of electronic confirmation systems where possible. Usage of electronic confirmation systems enhances timeliness, security and efficiency of the confirmation process. However, mandatory use of electronic confirmation systems may be difficult, when derivative transactions are used inside a securities structure, e.g. a CAT-Bond. Accordingly, other means of confirmation should remain a permissible.



We recognise the progress which has been made by the market participants on CDS transactions. CDS confirmation (cf. Para 21) is not exactly a case for MCA application because the relevant MCAs have not been updated following the 2005 ISDA Matrix Supplement. The electronic confirmation of CDS transactions is easier than many other derivatives transactions because parties following 2009 ISDA Big/Small Bang Protocols now agree on the basis of the of the ISDA Physical Settlement Matrix and the Standard Terms Supplements (International Index Cp. Ltd – ITRAXX), rather than using MCAs proper. The trading parties only need to agree on contractual aspects like trading volume, premium, underlying or the transactions type. The confirmation of other OTC contracts is more difficult, as it includes the requirement of being able to handle further product formulas.

An electronic confirmation system is more easily implemented on simply structured OTC derivatives. Electronic confirmation of complex derivatives is more difficult and costly to implement because certain features of complex derivatives such as return formulas, weightings, observation dates, or the definition of market disruption events are difficult represent and to compare within a electronic confirmation system.

Currently, different electronic platforms (e.g. CDS, interest rate swaps, FX) are used for trade confirmation, e.g. Markitwire. Multiple systems, however, interfere with the aim of a streamlined STP. Multiple confirmation systems increase the number of interfaces to be served and create high implementation and operating costs for the buy-side. However, because of the fluid nature of the market no indication of buy-side costs can be made at his moment.

Q8: Do you agree with the assessment done by CESR on the benefits and limitations of exchange trading of OTC derivatives? Should any other parameters be taken into account?

BVI broadly agrees with CESR`s analysis. The conditions on (direct) access of smaller financial service firms - in particular investment fund management companies - to CCP and exchange membership need to be carefully calibrated. We have provided in the context of the EU Commission derivatives market consultation an alternative model for direct market access to a CCP which works in case of default of a clearing member. We are happy to explain the model in more detail at your request.



With respect to the provision of liquidity we would like to stress that liquidity is not created automatically by exchange trading. The trend towards liquid, smaller average trade size on cash markets seems to indicate, that exchanges can be cost efficient market for such trades. The important role of liquidity providers needs to be as analyzed in more depth, especially for large trades.

Q9: Which sectors of the market would benefit from/ be suitable for (more) exchange trading?

In practice depending on appropriateness of the specific standardisation all sectors could benefit from exchange trading. For example, there is a need for more forward products on single stocks. Also index CDS could be exchange traded.

Q10: In your view, for which sectors of the market will increased transparency associated with exchange trading increase liquidity and for which sectors will it decrease liquidity? Please specify.

BVI thinks that it is very unlikely that transparency will automatically create liquidity. The complexity of each market segment needs to be analysed in-depth before requiring exchange trading. Trading volumes will depend on the willingness of market participants to create fair two way prices also in periods of stress. It is important to create sufficient incentives for liquidity providers to do their job.

Q11: Do you identify any other elements that would prevent additional OTC derivatives to be traded on organised platforms?

One member mentioned that barriers to trading may result from accounting needs, e.g. adherence to hedge accounting and variable annuity hedging rules. For example, large hedge transactions are preferably traded with one or two counterparties only.

Q12: How should the level of liquidity necessary/relevant to exchange trading be measured?

BVI proposes the analysis of trading volumes in number of contracts, the nominal and the open interest.



Q13: Do you agree with CESR's assessment of the characteristics and level of standardisation which are needed for a contract to be traded on an organised trading platform?

BVI broadly agrees with the CESR analysis. It needs to be recognized, however, that institutional market and product needs are different from retail needs, e.g. because many institutional investors are limited by regulation in their investments.

Q14: Is the availability of CCP clearing an essential pre-determining factor for a derivative contract to be traded on an organised trading platform? Please provide supporting rationale.

We believe that CCP clearing will be an important factor as it allows for netting of positions and efficient oversight of the transaction process. Some derivative positions, however, may not yield themselves for CCP clearing. Full mandatory collateralization of derivative trades may be a suitable alternative to CCP usage. Derivative transactions concluded in the context of CAT Bond transaction should be exempt from a clearing through CCP. These transactions are fully collateralized (collateral posted is not limited to margin, but covers full payment obligation under derivative contract). As a result, CAT Bonds do not create a systemic risk. Furthermore, there should be an exemption for intra group transactions: as a result of the CCP's involvement, the intra group relationship would be transformed into two contractual relationships, involving the two group companies and twice the CCP. This would artificially increase revenues at group level. Furthermore, the posting of collateral between group companies may create inefficiencies.

Q15: Is contract fungibility necessary in order for a derivative contract to be traded on an organised trading platform? Please provide supporting rationale.

In practice only fungible contracts will attract the interest of a sufficient number of willing buyers and sellers in order to create a real market place.



Q16: Which derivative contracts which are currently traded OTC could be traded on an organised trading platform? Please provide supporting rationale.

We think that index CDS, plain vanilla swaps, forward swaps and swaptions as well as plain equity options and equity forwards can be traded on an organised trading platform. These contracts are already highly standardised. For other derivative product classes more detail on the envisaged trading venues is necessary to be able to engage in a deeper analysis.

Q17: Please identify the derivative contracts which do trade on an organised trading platform but only to a limited degree and could be traded more widely on these types of venues.

See q.16.

Q18: In the OTC derivatives context, should any regulatory action expand the concept of “exchange trading” to encompass the requirements set out in paragraph 86 and 87 or only the requirements set out in paragraph 86? Please elaborate.

We believe that both para 86 and 87 should be considered as they accomplish a fairer and non discriminatory access to derivative trading. The new trading venues should not compromise the ability of the market in general and participants individually to execute large quantity transactions. Alternative models of direct CCP access as explained above should be considered too in order to avoid higher market and counterparty risk f e.g. investment fund management companies don't use CCP to the maximum.

Q19: Do current trading models and/or electronic trading platforms for OTC derivatives have the ability to make pricing information (both pre- and post-trade) available on a multi-lateral basis? Please provide examples, including specific features of these models/platforms.

No comment.



Q20: Do you consider the SI-regime for shares relevant for the trading of OTC derivatives?

The SI concept needs to be carefully considered in regards to price transparency and fair access in order to enable best execution to the buy-side. SI requires a liquid market in the relevant product on another trading venue in order to reflect de facto market prices in the SI system itself. Therefore some members do not consider SI as a relevant concept in the derivatives discussion.

Q21: If so, do you consider that the current SI-regime provides the benefits described above which ‘exchange trading’ may offer or are amendments needed to the SI obligations to provide these benefits to the OTC derivatives market?

No comment.

Q22: Which characteristics should a crossing network regime, as envisaged in the review of MiFID, have for a CN to be able to be qualified as a MiFID “organised trading venue”?

A crossing network should support at least both pre/post trade transparency and fair access to all parties.

Q23: In your view does the envisaged legislative approach in the US leave scope for regulatory arbitrage with the current EU legislative framework as provided under MiFID? Would regulatory measures taken in the EU to increase ‘exchange trading’ of OTC derivatives help to avoid regulatory arbitrage?

BVI is not able to comment at this stage in sufficient detail on the envisaged US regulation. Regulatory arbitrage cannot be avoided if there is no harmonisation between EU and US regulation.



Q24: The Commission has indicated that multi-laterality, pre- and post-trade transparency and easy access are key aspects of the concept of “on exchange” trading. Do you agree with CESR applying these criteria in its further analysis of what this means in the EU context, in particular in applying MiFID to derivatives trading?

Yes.

Q25: If not, do you consider that MiFID requirements and obligations should be refined to cover deviating characteristics of other electronic trading facilities? Please elaborate.

No comment.

Q26: Are there any market-led initiatives promoting ‘exchange trading’ that the regulators should be aware of?

No comment.

Q27: Which kind of incentives could, in your view, efficiently promote greater trading of standardised OTC derivatives on organised trading venues? Please elaborate.

We believe that more market participants should have direct access to a CCP because the use central counterparties is one of the conditions for trading on organised derivatives platforms. Understanding by the market place of clear and demonstrable benefits of organised trading in terms of better price formation, increased market depth, legal certainty, lower cost and fees is better than setting certain incentives.

Q28: Do you believe there would be benefits in a mandatory regulatory action towards greater trading of standardised OTC derivatives on organised venues? Please elaborate.

Not necessarily - if mandatory regulatory action would result in a loss of trading volume or loss of a complete market segment there would be less hedging possibilities for (large) users and more systematic risk. There is also the potential for arbitrage if new OTC products contravene the regulatory push for trading on organised venues.



2. CESR Consultation on Transaction Reporting on OTC Derivatives and Extension of the Scope of Transaction Reporting Obligations

Q1:

Do you agree with the solution proposed by CESR for the organisation of transaction and position reporting on OTC derivatives?

BVI supports in principle option 2. The other option requires additional infrastructure investments by the buy-side.

We are in favour of using also a CCP as a reporting channel for the buy-side transactions to trade repositories (TR). Sell side firms should be responsible for reporting the transactions to TRs.

Q2:

Do you have any other views on the possible ways to organise transaction and position reporting on OTC derivatives?

The regulators need to consult with the market place on the relevant contract categories to be reported and for each contract category the timing of reporting and level of granularity of information needed. Such consultation should help defining an industry wide action plan for the implementation of a comprehensive reporting system which will increase safety and soundness in the derivatives markets going forward. The most important aim is to achieve a single (MiFID compatible) reporting standard and message formats between the reporting parties, TRs, CCPs, regulators and other service providers (e.g. collateral management agents). A reduction in the number of required report receiving parties is also needed. Otherwise cost and complexity of the system may become unmanageable.

The involvement of the European Parliament in the requirement of transaction reporting should be upheld. Level 1 should specify the required reporting in enough detail. Any reporting should be applied EU wide and national actions on the basis of Recital 45 MiFID should be limited.

Some derivative products might not be recorded in a TR any time soon because of their low monetary value or low volume of transactions and/or complexity of the instrument. These are the products which are less likely to be standardised in the foreseeable future, which makes their recording in the TR difficult and cumbersome. Any extension of transparency must be



carefully calibrated. BVI believes that transparency is good, but only if it does not reduce liquidity. The reporting of positions and transactions on a daily basis may be difficult as many products are not daily priced, valuations may differ between counterparties, and reconciliation within a TR may require additional rules and requirements.

Q3:

Do you agree with the extension of the scope of transaction reporting obligations to the identified instruments?

We agree in particular with the extension of the reporting requirement to all instruments that could potentially constitute market abuse.

We hope you will find our comments helpful. Our response can be made public.

Yours sincerely

BVI Bundesverband Investment und Asset Management e.V.

(signed)
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(signed)
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