

16 August 2010

## **CESR's consultation on**

# **Standardisation and exchange trading of OTC derivatives**

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### **Reply of NASDAQ OMX**

The NASDAQ OMX Group, Inc. delivers trading, exchange technology, listings and other public company services and post-trading services across six continents. It lists approximately 3,700 companies from 50 countries and from all industry sectors. NASDAQ OMX offers various capital raising and trading solutions to companies around the globe, including its U.S. listings market, NASDAQ OMX Nordic, NASDAQ OMX Baltic, First North, U.S. 144A, NordPool and N2EX. NASDAQ OMX Nordic and Baltic include exchanges in Stockholm, Helsinki, Copenhagen, Iceland, Tallinn, Riga and Vilnius. NASDAQ OMX offers trading across multiple asset classes including equities, derivatives, debt, commodities, structured products and ETFs. NASDAQ OMX also offers post-trading services in the form of central counterparty derivatives clearing. NASDAQ OMX Group technology supports the operations of about 70 exchanges, clearing organizations and central securities depositories in more than 50 countries.

NASDAQ OMX notes that the G20 has called for "all standardised OTC derivative contracts to be traded on exchanges or electronic trading platforms, where appropriate". Other jurisdictions, like the US, have now adopted legislative provisions to this effect. It is therefore unfortunate that CESR is dealing with this important aspect of financial market regulation in a four weeks consultation rushed during the summer holiday period. A proper consultation process will be needed. NASDAQ OMX provides below preliminary replies based on the analysis that it has been possible to carry out under the imposed timeframe.

#### **Executive summary**

##### **Exchange trading**

Key advantages of trading of OTC derivatives on multilateral venues include: more competition and transparency of prices of OTC derivatives, easier offsetting of transactions, potential for enhanced liquidity, reduced costs of trading. Trading on organised venues also provide clear and public information about the rules governing the trading and admission to trading of financial instruments. In particular, it would allow transactions to be executed in the most economically efficient ways and reduce the cost for participants who are hedging their risks. When prices are made public, it also allows determining more easily the fair market value of these contracts. Trading according to clear membership and trading rules mitigates uncertainty regarding the transaction process (including confirmation) as well as about what has been traded i.e. it allows for product transparency. The regulatory environment applicable to regulated markets supports clarity and mitigates risks.

We also believe that issues related to transparency for large transactions and market impact on organised venues can be dealt with and organised venues already offer appropriate arrangements.

Important factors needed for a contract to be traded on an organised trading platform include the size of the underlying, the diversity of market participants, as well as liquidity of the contracts. Regarding availability of CCP clearing, although most of the derivative contracts traded on an exchange would also be CCP cleared, we are not convinced that this is an absolute requirement. Some products may be traded without being cleared. Moreover, fungibility of contracts across markets and platforms should not be sought after as this would limit innovation, competition and choice for end-users.

We consider that credit derivatives, equity derivative products, interest rate swaps, commodities contracts -in particular electricity- and fixed income products would benefit from/ be suitable for (more) exchange trading. Some products however, like highly customized products, are not suitable for trading onto a multilateral venue.

We also underline that the regimes of RM and MTFs are the only ones able to deliver the benefits of organised multilateral venues that the G20 wants to apply. Electronic trading facilities that do not comply with the MTF regime should not be considered as organised multilateral venues. The SI regime is not equivalent to multilateral trading and does not provide the benefits of multilateral trading.

If powerful incentives to promote increased transparency and choice for end-users allowed by trading of standardised OTC derivatives on organised trading venues can be found, this would be the preferred approach. We note that the policy debate in the US underlined the difficulty to find such incentives since market participants providing OTC contracts on a bilateral basis have interest in such market remaining bilateral to develop their business. This is the reason why the US regulatory regime has adopted a mandatory approach which is more likely to foster trading of standardised OTC derivatives on organised trading venues.

In order to give effect to the conclusions of the G20 in respect of OTC markets a global approach in regulating such markets is important. If due to the dynamics of the OTC derivative markets, an approach based on incentives is not possible, a regulatory action towards greater trading of standardised OTC derivatives on organised venues appears to be the most effective option.

#### Standardisation

We agree in general with the concept and analysis of standardisation of OTC derivatives developed by CESR. We also agree on the benefits of standardisation (including reduction of operational risk, facilitate clearing as well as multilateral trading, facilitate the reporting, monitoring and sharing of information for regulatory purposes, enhance contractual certainty) and that greater standardisation is desirable. We note that although exchange traded products have a higher degree of standardisation than bilateral OTC products, exchange traded products do offer a certain level of flexibility including on maturity dates or nominal amounts.

We believe that the focus of regulatory action should be on asset classes rather than elements of standardisation. In addition, electronic confirmation systems are an important tool to reduce operational risk and would be simplified by standardisation but mandating their use will not

achieve what the G20 wants to accomplish with more standardisation leading to trading on organised venues.

### **Detailed replies**

### **Standardisation**

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*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?*

We agree in general with the concept of standardisation (i.e. legal uniformity, process uniformity (automation) and product uniformity) and the analysis of standardisation of OTC derivatives developed by CESR. This analysis should however be extended to other important derivative products such as contracts for difference (CFDs) and warrants. These products should also be included for ensuring that all market segments are properly assessed.

We view as standardised derivatives the following products: credit derivatives, equity options and futures/forwards, the fixed income options and futures/forwards. Certain interest rate and Foreign Exchange (FX) products as well as electricity contracts have achieved a high degree of standardisation. Standardised products moreover include all plain vanilla products (especially equity options) as well as the so-called look-alike contracts i.e. contracts that reproduce the terms of exchange contracts but which are negotiated OTC.

All the products mentioned above have the potential to be further standardised.

In addition, we would like to note that the term "standardised" suggests that all customized aspects of the contract need to be stripped away, which is not the case. This has been particularly troubling to corporate end-users who see tremendous value in these products. Although exchange traded products have a higher degree of standardisation than OTC products, exchange traded products do offer a certain level of flexibility including on maturity dates, nominal amounts, etc, and still keep other terms standardised. In other words, exchange traded products can cater for some flexibility and the choice for end-users is not between fully customized products, on the one hand, and entirely rigid offer from exchange traded products, on the other hand. To some extent the standardisation of exchange traded products is based on the requirements in MiFID regulation (art. 35-37) that specify the basis for admitting certain instruments. Besides, there is constant innovation and development of new products well suited to exchange trading. Especially in the area of what CESR calls "product uniformity" there is room, within the regulated market's rules (legal uniformity), for differentiation to cater for customers needs. For example NASDAQ OMX offers flexibility on the specific products contract base (underlying), expiry date, price and option types, within the specifications of a given contract i.e. legal framework. We also offer the possibility to execute trades agreed under voice brokering within the rules of regulated markets. This set-up safeguards that there is possibilities for innovation and adaptation to customer demands.

Some products however, like highly customized products, are not suitable for trading onto a multilateral venue. This is to a large extent independent from their ability to be cleared. As clearinghouses adapt OTC risk management systems and approaches they are able of offering

cleared solutions for the vast majority of these products. If there exists a strong valuation backbone and sufficient market liquidity to cure defaults then there is no good reason why these products cannot be cleared.

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?

We concur with CESR on the benefits identified for standardisation, including reduction of operational risk, facilitate clearing as well as multilateral trading, facilitate the reporting, monitoring and sharing of information for regulatory purposes, enhance contractual certainty.

Regarding the possibility of unwinding positions more easily and pricing comparability, although standardisation helps, we believe that it is mainly multilateral trading that would deliver such benefits and not standardisation per se.

It would also allow for more competition and choice for the benefit of end-users.

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

Yes, greater standardisation is desirable as this will allow for more competitive, fair and orderly markets for the products concerned with more liquidity available to end-users. It will also allow for increased transparency, reduction of operational risks as well as better surveillance and monitoring of OTC markets. Against this background, those products that can be standardised should be standardised.

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

Regulators and industry participants need to continue working closely together on possible measures. Moreover, regulators should be more engaged in the monitoring of the progress made by the industry in this respect.

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

We have not identified specific obstacles to standardisation that regulatory action could remove but a detailed study of such possible obstacles should be carried out with the industry.

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

We believe that the focus should be on asset classes rather than elements of standardisation. The elements will depend on each and every asset class although some elements may be common to all. In order to ensure efficiency, it therefore seems preferable to start with asset classes for which standardisation is readily achievable, moving forward to asset classes less prone to standardisation at a later stage.

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.

Electronic confirmation systems are an important tool to reduce operational risk for derivative transactions negotiated OTC and electronic confirmation would be simplified by standardisation. However, mandating the use of electronic confirmation systems will not achieve what the G20 wants to accomplish with more standardisation leading to trading on organised venues.

Moreover, it is difficult to quantify costs for the creation and wider use of electronic confirmation systems but there will surely be costs associated.

### **Exchange trading**

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?

The main benefits of exchange trading will be more competition between those currently providing OTC instruments on a bilateral basis; better price and general market transparency; easier offsetting of transactions; the potential for enhanced liquidity; and reduced costs of trading. We do not see any obvious drawback as customised and structured products will remain available.

We do not agree with CESR that trading on organised venues poses problems in terms of transparency for large transactions and exposes participants to market impact thus, forcing transactions to be carried out OTC. Exchanges have for a long time offered responses to market impact for large orders by reducing transparency as appropriate. In the equity space, MiFID has established a whole regime of transparency waivers to cater for this problem that could be used in the derivative space with necessary adaptations.

Although it is correct that most innovation, in terms of products, comes from the OTC space as firms have the direct contact with end-users. However, multilateral venues constantly innovate both with regard to products admitted to trading and the way they are traded. This includes securing fair and orderly markets, in particular by adapting the rules that apply to the markets they organise ( e.g. product transparency, surveillance of markets, monitoring of participants).

We also want to underline that the possibility to unwind easily positions is one of the key benefits that trading on organised multilateral venues offers. Especially, since multilateral trading allows non-discretionary access by participants permitting them to conclude transactions with multiple counterparties.

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

Credit derivatives, equity derivative products, interest rate swaps, commodities contracts -in particular electricity- and fixed income products would benefit from/ be suitable for (more) exchange trading. We note that regarding the electricity market, trading is already very developed in the Nordic markets.

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.

For all standardised OTC contracts and in particular credit derivatives, equity derivative products, interest rate swaps, commodities contracts -particularly electricity- increased transparency and trading on organised multilateral venues have the potential to increase liquidity.

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

Market participants providing OTC contracts on a bilateral basis have interest in such market remaining bilateral to develop their business.

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

Whereas it is not possible to come up with a specific threshold at this point, we want to underline that the level of liquidity necessary to exchange trading will be different depending on the product concerned. There will be important differences from one product to the other.

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?

We agree in general with CESR's analysis. As identified by CESR, important factors include the size of the underlying, the diversity of market participants, as well as liquidity of the contracts. Regarding availability of CCP clearing and fungibility we are more nuanced (see replies to the specific questions below).

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.

Although most of the derivative contracts traded on an exchange would also be CCP cleared, we are not convinced that this is an absolute requirement. Some products may be traded without being cleared. The trading would bring some benefits like product transparency, price transparency, non discretionary access but the counterparty risk would therefore not be dealt within a CCP environment. This depends on how the product is built. For instance, warrants are traded but not CCP cleared. This could also apply to contracts for difference (CFDs) that can be traded on a multilateral venue and can or cannot be cleared. For instance, commodities CFDs traded on NordPool are both traded and cleared whereas other venues propose only trading services.

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

Contracts traded on a given market or platform need to be fungible to be traded and allow for netting i.e. a specific contract will have certain specific terms which will not change with the counterparty. Nonetheless, an exchange can offer a series of contracts with similar terms that cater for the granularity that may be needed by participants. For contracts to be traded in a multilateral

way the granularity will have to be balanced against the need to ensure that the contract accommodates a large number of users and therefore ensuring sufficient liquidity.

In addition, fungibility of contracts across markets and platforms should not be sought after as this would limit innovation, competition and choice for end-users.

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

As mentioned above, we believe that any product which is sufficiently standardised can be traded on organised trading platforms. More specifically, contracts for which multilateral trading is available but which are privately negotiated (i.e. so-called look-alike contracts) could be traded without difficulty on organised trading platform.

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.

This is in particular the case for credit derivatives, equity options, IRS, certain commodity contracts, fixed income products.

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.

The concept of exchange trading / multilateral trading should encompass the requirements set out in paragraphs 86 and 87 and not only those of paragraph 86 that are too limited. For instance, easy market access is not sufficient for multilateral trading, it is imperative that non-discretionary access applies otherwise the choice for end-users will be limited. Likewise, non-discretionary and transparent rules as well as operational resilience and surveillance/monitoring of the compliance with the rules of the venue are central to ensure that the benefits of multilateral trading can be obtained. Authorization/ regulation and monitoring by competent authorities are also key to ensure a level playing field between venues and that they live up to their undertakings.

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.

Only regulated markets and MTFs make pricing information available on a truly multilateral basis i.e. in a way that prices are accessible to all users and with the benefits attached to multilateral negotiations. Some platforms may have elements of such benefits but on a discretionary basis and for a limited number of participants. Single-dealer platforms are generally not equivalent to regulated markets and MTFs but if they are, they should be classified as MTFs and comply with the obligations attached to this regime which are imposed for protecting investors.

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

The SI regime brings some transparency when compared with purely OTC negotiations. However, the SI regime is not equivalent to multilateral trading and does not provide the benefits of

multilateral trading. Moreover, the SI regime is open to review due to the fact that it has attracted only a limited number of firms in the case of securities trading. With these considerations in mind, we think that the SI regime would not bring any significant improvement to the trading of OTC derivatives.

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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?

The SI regime is not equivalent to multilateral trading and does not provide the benefits of multilateral trading, far from it.

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"?

As mentioned above, to be qualified as an "organised trading venue" a crossing network would have to meet the characteristics of an MTF (i.e. those listed under paragraphs 86 and 87). The definition of an MTF is not limited to equity only. Having several regimes with similar, but not equivalent characteristics, will undermine fair competition and start a race to the bottom in terms of protection of investors.

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?

The US legislation has taken a mandatory approach for the trading of OTC derivative products. Although all the details of how the legislation will work in practice are not known at present, the notion of swap execution facilities in the US seems very similar to the concept of MTF in Europe, in particular in terms of access. It follows that, in Europe, regulatory measures to increase trading of OTC derivatives on multilateral venues (either regulated markets or MTFs) would help reducing the risks of regulatory arbitrage between the US and European regulations.

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?

Please see reply to question 18.

The concept of exchange trading / multilateral trading should encompass the requirements set out in paragraphs 86 and 87 and not only those of paragraph 86 that are too limited. For instance, easy market access is not sufficient for multilateral trading, it is imperative that non-discretionary access applies otherwise the choice for end-users will be limited. Likewise, non-discretionary and transparent rules as well as operational resilience and surveillance/monitoring of the compliance with the rules of the venue are central to ensure that the benefit of multilateral trading can be



obtained. Authorization/ regulation and monitoring by competent authorities are also key to ensure a level playing field between venues and that they live up to their undertakings.

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.

The regimes of RM and MTFs are the only ones able to deliver the benefits of organised multilateral venues that the G20 wants to apply. Electronic trading facilities that do not comply with the MTF regime should not be considered as organised multilateral venues and therefore trading standardised OTC contracts on them should not be considered as meeting a requirement of trading standardised OTC contracts on an organised multilateral venue. Such electronic trading facilities would continue to offer trading service on non-standardised OTC derivative contracts.

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

We are not aware of any broad market-led initiative promoting exchange trading except for the actions taken by exchanges to promote their services and creating new regulated markets. In this perspective, we wish to underline our recent initiative in creating N2EX a new power market in cooperation with the Future and Option Association.

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

If powerful incentives to promote increased transparency and choice for end-users allowed by trading of standardised OTC derivatives on organised trading venues can be found, this would be the preferred approach. We note that the policy debate in the US underlined the difficulty to find such incentives since market participants providing OTC contracts on a bilateral basis have interest in such market remaining bilateral to develop their business. This is the reason why the US regulatory regime has adopted a mandatory approach which is more likely to foster trading of standardised OTC derivatives on organised trading venues.

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.

We further note that in order to give effect to the conclusions of the G20 in respect of OTC markets a global approach in regulating such markets is important.

If due to the dynamics of the OTC derivative markets, an approach based on incentives is not possible, a regulatory action towards greater trading of standardised OTC derivatives on organised venues appears to be the most effective option.

Nonetheless, we consider that any regulatory action needs to be proportionate and well focused to ensure that only those products that can be multilaterally traded are directed towards organised venues. This should not limit innovation of new products: both organised and OTC venues will keep the possibility to create new products.