

**EFAMA reply to CESR's Consultation Paper on standardisation  
and exchange trading of OTC derivatives**

EFAMA<sup>1</sup> welcomes the opportunity to reply to CESR's Consultation on standardisation and exchange trading of OTC derivatives.

**GENERAL COMMENTS**

EFAMA has strongly supported from the beginning the move to the use of central clearing of OTC derivatives. With regard to exchange trading, however, many among our members are concerned about the pace of regulatory action and consider that such a move is premature while the market is dealing with such transformational changes. Regulation should not be rushed but carefully conceived and implemented, and all market participants need more time to prepare.

Product standardisation alone is likely to take longer than assumed by legislators if all the relevant issues (legal, operational, and trading) are properly considered.

In view of the changes post-MiFID in the European landscape for trading venues, it is not enough to mandate exchange trading without considering the range of what is permitted on other venues or platforms, and what the full range of regulatory requirements should be on the exchanges in relation to monitoring derivatives markets for abuse.

Finally, EFAMA regrets that regulators appear to draw little distinction between the service providers – banks, dealers, brokers, trade repositories – and market users, who in turn do not include only corporates but also institutional investors such as investment managers, pension funds, insurance companies. It is a very fragmented group, with less resources and interest in derivatives, as they are not their main business. However, derivatives regulation will have a large impact on market users (and their clients), and their interests should be equally taken into account. After all, their clients are – directly or indirectly – retail investors and pensioners, whose interests should be protected by regulators.

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<sup>1</sup> EFAMA is the representative association for the European investment management industry. It represents through its 26 member associations and 43 corporate members approximately EUR 13 trillion in assets under management, of which EUR 7 trillion was managed by approximately 52,000 funds at the end of December 2009.

**DETAILED REPLIES****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?**

EFAMA largely agrees with CESR's assessment, but we wish to add the following comments:

- CESR mentions in Para. 8 four uses for derivatives – hedging, funding, speculation and arbitrage. The meaning of “funding” is unclear. We believe that the following uses should also be included in the list: EPM (efficient portfolio management), risk management and liability matching.
- “Standardised” products should continue to offer the necessary flexibility around tenors, coupons and maturity dates, in particular for interest rates and FX derivatives.
- Good progress has been made in the past two years on several fronts, including standardisation and electronic confirmation. Although we agree on the possible benefits, it is important that the actual needs of end users be taken into account, and that regulation not be rushed which could jeopardize the usefulness of derivatives markets for them.
- Not only non-financial institutions could be limited in their hedging opportunities and potentially exposed to basis risk. Pension funds in particular enter into OTC transactions for the purposes of hedging their liabilities through Liability Driven Investment (LDI) strategies.

**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?**

EFAMA broadly agrees with CESR's assessment, but we wish to stress the legitimate need for bespoke products, and welcome the comments from CESR in Para. 40 (1). In particular, Liability Driven Investment (LDI) requires customisation, and standardisation is not therefore to the benefit of LDI investors.

It is unknown whether the same level of liquidity as it currently exists via bilateral arrangements may be created via exchange trading for all OTC instruments. Some EFAMA members suggest that studies should be undertaken to determine what level of liquidity improvements can realistically be achieved.

Other aspects that should be considered are the large associated costs that would be caused by a move to standardise lower volume products. Industry-led vendor solutions still need to resolve many of the issues related to CCP use and, due to inconsistent approaches among CCPs, they will cost more to implement.

It is crucial that sufficient time be allowed for implementation: CESR must take into account that the buy side has to wait on decisions and implementation until the sell side and the CCPs have completed their work, given that the only model on offer so far is that of indirect access to CCPs.

EFAMA urges CESR to consider that legal contract standardisation may not be based only on ISDA master agreements. CCPs should not impose the use of a specific master agreement, and national master agreements backed by high market acceptance such as the German Master Agreement (“Deutscher Rahmenvertrag”) should be acceptable besides ISDA documentation. The German master agreement is better adapted to the specific legal structure of German investment funds (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 applied under a national master agreement.

Furthermore, it should also be mentioned that ISDA documentation does not cover all derivative contracts, as it does not include OTC contracts on a commodity index. For this reason, some among our members do not agree with CESR’s assessment that the degree of standardization of commodity derivatives transactions may be considered as “reasonable”.

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

Yes, EFAMA agrees that greater standardization is desirable as long as market liquidity is enhanced and operational risk is reduced, but many among our members consider that it would be preferable to encourage contract standardisation rather than mandating it.

The aim should be to ensure that the standardised contracts are fungible. Some EFAMA members consider that only the high volume products should be standardised, which would capture the majority of trading and which already display a higher level of consistency in structure and legal framework. For other products, volumes might be insufficient to justify a significant investment in electronic trading and confirmation systems, and it is unlikely that liquidity would benefit from exchange trading.

Many issues remain to be defined regarding derivatives clearing, such as legal certainty (concerning contractual, property rights, trust arrangements), operational risk (systems, segregation, margining and collateralisation, contract portability, client and regulatory reporting) and trading (derivative structures, cost). Certainty in regulation and practices must be achieved before standardisation can be truly achieved.

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

Regulators so far have been working only with ISDA, sell-side entities and CCPs. EFAMA deeply regrets that end users of the market have not been asked by regulators to participate in the crucial work relating to the structure and governance of CCPs. We urge regulators to correct this asymmetry and seek out the input of a broad spectrum of end users. The same should also apply to detailed proposals on product/contract standardisation for the market as a whole.

End user/buy side views must be taken into account in all future regulatory developments, and industry expert groups/consultative bodies at EU level should be involved in the process.

There needs to be also public consultation, and sufficient time must be granted to reply. The timeframe for this consultation, for example, is far too short (also because it includes the summer holiday period) in view of the importance of the subject.

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

Derivative standardisation has so far been “managed” by the sell-side, although end users benefit more from standardisation and therefore their interests are likely to be closer to those of regulators.

Regulators should encourage a fair representation of all market participants (particularly those of the buy side) in the standard setting organizations and on CCP risk committees, and take note of their comments regarding standardisation of contracts and products.

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

Many EFAMA members believe that regulators should prioritise those products which have already been identified as capable of standardisation (permitting timely electronic confirmations, greater use of STP, adoption of standard contract terms and standardised definitions). Rather than attempting to tackle many asset classes and product types, focus on a few products would be preferable.

Some among our members suggest that regulators should focus on the areas of highest volumes such as CDS, IRS and equity markets and maintain a proportional response to other markets until such time as volumes become large enough to justify the investment.

Others consider that regulators should focus on a certain element of standardization and a certain asset class: with respect to element standardization regulators should insist on adherence to ISO reference data standards for the identification of parties, transactions, and accounts, in particular the BIC and ISIN codes; among asset classes to be standardised, the instruments which are most important to the stability and the functioning of the financial markets (e.g. CDS, FX) should be prioritised.

A focus on asset class is justified for some members by the fact that a certain level of standardisation (legal, process or product uniformity) which is vital in one asset class may be less important in others.

**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.**

EFAMA recognizes the possible benefits of electronic confirmation systems, and some of its members support CESR's aim to require their use where possible. However, we are concerned that mandatory use of electronic confirmation systems may impose prohibitive costs on smaller investment managers, making it impossible for them to hedge their risks and representing a barrier to entry.

Infrastructure costs to access a system are reported by some to be for example £100,000 p.a. per system, plus the costs of building links to systems, as well as supporting upgrades/changes. Currently there is little interoperability among platforms, so such costs could be multiplied.

### **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?**

EFAMA disagrees with CESR's expectation that exchange trading for derivatives will necessarily enhance liquidity, as liquidity is not created automatically by exchange trading, and many OTC transactions may not be entered into at all if they are forced to move to exchange. The important role of liquidity providers needs to be analyzed in more depth, together with the impact of increased transparency.

A majority of EFAMA members considers that CESR does not clearly articulate the process by which contracts could be suitable for exchange trading: usually exchange trading is the start of the process to introduce new products, not the end. For this reason, they considered it better to let the market take its course.

Many EFAMA members are also concerned that too much transparency is likely to impact anonymity in the market place and reduce liquidity, particularly for large

transactions. For this reason, they believe it would be better to concentrate on central clearing for a few products at a time, leaving the question of exchange trading to be determined at a later date when the market has absorbed the impact.

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

EFAMA has no further comments.

**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.**

It is very difficult to answer this question a priori, but we refer CESR to published academic research on existing exchange markets, cash equities in particular. However, it is very unlikely that transparency will automatically create liquidity. Trading volumes will depend on the willingness of market participants to enter into contract, also in periods of stress. It is important to create sufficient incentives for liquidity providers to provide their service.

See also our reply to Q8.

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

Exchanges and their members have to be willing to trade the contracts specified.

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

Exchange platforms are open for trading their contracts throughout the specified hours, regardless of actual volumes, which can vary greatly. Natural liquidity (buy and sell interest) is very helpful but of itself does not define the market. Some EFAMA members would therefore disagree that a level of liquidity should be set to consider the introduction of exchange trading. Standardisation should focus on the ability to produce fungible contracts, and where contracts are truly fungible, the conditions for introducing exchange trading are met, regardless of the interest in trading.

Other EFAMA members propose the application of trading volumes in number of contracts, the nominal and the open interest to measure the level of liquidity for exchange trading.

A factor that should be considered by CESR is that liquidity shall vary over time for a given contract. For example, on entering into a five year CDS, there may be plenty of

liquidity, but over time (approaching maturity) there is less likelihood that liquidity for such an instrument will be sufficient. Therefore, it is not possible to guarantee the continued liquidity throughout the life of an initially seemingly very liquid instrument.

**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?**

Many EFAMA members broadly agree with CESR's assessment.

Some welcome in particular CESR's recognition (in paragraph 83) that a high degree of standardisation may not be sufficient to successfully support trading on organised platforms and mention the example of OTC property total return swaps, which are relatively standardised but not necessarily suitable for trading on organised platforms due to low volume and liquidity.

**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.**

A majority of EFAMA members do not consider that the availability of CCP clearing is essential. There are currently single dealer electronic platforms which do not link to CCPs, and it is not impossible for exchanges to handle settlement without use of an external CCP. However, the presence of a CCP is a very substantial aid to trading through an exchange platform.

Other EFAMA members believe that CCP clearing is an important factor, as it allows for netting of positions and efficient oversight of the transaction process.

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

Yes, contract fungibility is necessary. Without fungibility it is difficult to sustain continuous trading of a contract (note that this is not a comment on the level of trading that actually occurs). Lack of fungibility would require individual listing of contracts, which is complex and unlikely to support sufficient liquidity.

Fungibility would also be beneficial to have the ability to trade on one platform and settle on another.

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

The next contracts to be considered should be CDS indices, as these are already fairly well standardised, generally highly liquid and could be constructed to provide fungible contracts.

However, many EFAMA members reiterate their opinion that it would be best to let the market evolve at its own pace, once the central clearing of contracts is implemented.

**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.**

EFAMA has no comment.

**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 requirements in both paragraphs are relevant.

CESR should clarify whether the references to “exchange trading” for OTC derivatives imply that only an exchange platform will be available for trading or whether, as with cash equities, a range of different platform types may be offered.

**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.**

Current trading models and trading platforms for OTC derivatives can make pricing information available on a multi-lateral basis. However, lessons must be drawn by regulators from the damaging impact of data fragmentation due to MiFID in the equity market, and it would be futile to follow the same approach for derivatives. Furthermore, care must be taken that end user positions are not exposed, and thus subject to gaming by other market participants

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

No.



**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?**

We do not consider that the SI regime has provided the benefits described. Nor do we believe that the SI regime provides an appropriate model for OTC derivatives trading, as SIs are not obliged to trade with any counterparty.

**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 majority of EFAMA members do not consider that crossing networks are the same as “organised trading venues” in MiFID. Crossing networks do not provide open access the same way as organised trading venue.

**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?**

It would be preferable if the US and EU regimes were similar, but in practice there have always been substantial differences between existing organised markets in the two regions, and to our best knowledge this has rarely produced regulatory arbitrage. From an end user perspective, we would welcome if both market regimes promoted high standards intended to protect investors.

**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, EFAMA agrees.

**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.**

It is not necessary.

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

We are not aware of any.

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

Some EFAMA members consider that lower capital requirements in respect of derivatives trades on organised trading venues would be an appropriate incentive, also taking account of whether the exchange traded contracts are also centrally cleared. However, incentives for exchange trading should not be structured in such a way as to penalise bilateral OTC trading to a degree that prohibits it.

Other EFAMA members believe that more market participants should have direct access to a CCP, as the use of central counterparties is one of the preconditions for derivatives trading on organized trading platforms.

**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.**

EFAMA does not believe that it is appropriate to take mandatory regulatory action, particularly while the process of moving to central clearing is underway. It could prove to be a significant distraction from the main task without immediate benefits or it might result in loss of liquidity. Once fungibility of contracts is achieved, and there is more experience of clearing OTC products, regulatory action may be helpful if there is no market-led move to introduce exchange trading.

We hope these comments have been of assistance to CESR and will be pleased to provide any further clarification that might be required.

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