

16 August 2010

### FESE RESPONSE

#### CESR consultation paper on Standardisation and exchange trading of OTC Derivatives

Ref.: CESR/10-610

#### Introduction

FESE is a not-for-profit international association (AISBL) representing the interests of 23 Market Operators which operate a total of 42 exchanges (Regulated Markets and MTFs) in equities, bonds, and derivatives. FESE Members come from all the EU Member States and Iceland, Norway and Switzerland, as well as 7 Corresponding Members from European emerging markets.

#### Standardisation

#### 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?

Yes, FESE broadly agrees with CESR's assessment of the degree of standardisation of OTC Derivatives. In particular we note the following:

- **Credit Derivatives** – For benchmark Credit Default Swaps (CDS) index products there already is sufficient standardisation. The extent of standardisation has been increasing for a number of single names, driven by the move to central clearing for such instruments (standard roll dates, coupon levels, etc). Certain single names have already successfully been migrated to CCP clearing. There are increasing numbers of electronic platforms, particularly amongst the Inter Dealer Broker (IDB) community, and/or investment bank platforms.
- **Interest Rate Swaps (IRS)** – These products have achieved a high level of standardisation in standard tenors and structures driven by ISDA documentation and the already established clearing of IRS for a number of years, particularly for interbank trades. Again a number of IDBs, investment banks and vendors (e.g. Tradeweb) have established electronic platforms. Further standardisation where possible should still be encouraged.
- **Equity Derivatives** – ISDA documentation (which is in the process of being updated to provide greater standardisation) has contributed to standardisation, along with the fact that a number of OTC equity derivatives refer to exchange-listed products for transparent/objective pricing/settlement levels (sometimes referred to as “exchange look-alikes”), however, given the breadth of product and user base as well as the myriad of corporate actions, there are a number of structures that do not fulfil all of the criteria. In Europe, in particular, the exchanges have developed more of a hybrid offering for both standard and more non-standard (flex type) structures.
- **Commodity Derivatives** – The ISDA Master Agreement applies to commodity derivatives as well. There is active OTC trading of ‘look-alike’ derivatives and as exchange-traded liquidity grows this enhances the standardisation of OTC derivatives in the relevant commodities. Given the requirements of corporate users there are a number of bespoke structures. However, in the energy market in particular, given the migration toward clearing provided by platforms such as Clearport, ICE Clear and NordPool, there has been a greater move toward standardisation and migration from cleared to exchange traded products once sufficient liquidity has been achieved in cleared structures.

- **Foreign Exchange Derivatives** – Given the requirements of corporate users there are a number of bespoke structures which reduce the standardisation capability and there has been less movement currently to provide cleared services for more standardized structures.

**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?**

Yes, FESE broadly agree with benefits and limitations of standardisation noted by CESR. Where appropriate, and to the maximum extent possible, OTC derivatives should benefit from legal, process and product standardization in order to significantly reduce operational risk, facilitate clearing and facilitate reporting of regulatory information to supervisors. In other terms, all products that can be standardised should be standardised. On the other hand, it will be key to preserve the ability of non-financial users to hedge against risk using the instruments they consider appropriate. For this reason bespoke, niche, products will always have a place in world markets and should continue to allow non-financial users to carry out their day-to-day business.

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

Yes, we believe that standardisation is desirable - all products that can be standardised should be standardised. This can be achieved either through a mandatory regime, or through incentives. The latter should be reassessed by regulators on a regular basis and a mandatory approach should be pursued if the incentives approach does not deliver the desired outcome, which is to bring more OTC derivatives onto clearing and organised trading venues.

In addition, we note that the European Parliament suggested in its report 'Derivatives Markets: Future policy actions'<sup>1</sup> that all financial derivatives that concern public finances in the EU (including sovereign debt of Member States and local administration balance sheets) should be standardised and traded on exchange or other regulated trading platforms in order to promote transparency of derivatives markets for the public.

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

The European Parliament suggested in its recent report on 'Derivatives Markets: Future policy actions' that they backed the call for legal standardisation of derivatives contracts inter alia through regulatory incentives in the Capital Requirements Directive (CRD) regarding operational risk.

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

Regulatory action to incentivise CCP clearing of standardised/eligible products could represent an adequate incentive for further standardisation.

<sup>1</sup> Document P7\_TA(2010)0206 available for download at <http://www.europarl.europa.eu/sides/getDoc.do?type=TA&language=EN&reference=P7-TA-2010-0206>

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

Although both approaches are important, we believe that certain elements of standardisation should **not** be prioritised, as this would jeopardise the ability to reach the goal of standardisation because of the number of elements that would have to be analysed, which would be different per asset class. Hence, we believe that a more effective approach would be the prioritisation of certain asset classes.

**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.**

FESE members attach a huge importance to an efficient confirmation system. Exchange traded derivatives achieve confirmation rates of virtually 100% in real time, with registration and central clearing occurring simultaneously.

However, mandating the use of electronic confirmation systems would not be sufficient to achieve the objectives of the G20 in terms of trading of OTC derivatives, in particular because they are not directly linked to trading on multilateral organised platforms.

Moreover, it is important to acknowledge the risk of regulatory arbitrage should an agreement on electronic confirmation systems not be found. In the US, a system of electronic confirmation is in fact already in place; our focus at this point in time should also be that of working towards minimal differences between EU and US legislative frameworks.

#### **Exchange trading of OTC Derivatives**

##### **Benefits and limitations of exchange trading of standardised OTC derivatives**

**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?**

Yes, FESE members broadly agree with CESR's assessment of the benefits and limitations of exchange trading of OTC derivatives. We believe these benefits are particularly relevant for standardised/eligible OTC derivatives and more generally for derivatives eligible for CCP clearing traded on exchange.

These **benefits** are:

- **Higher confirmation rates** - Exchange traded derivatives achieve **confirmation rates of virtually 100%** in real time, with registration and central clearing occurring simultaneously. Although confirmation rates for certain standardised OTC derivatives have improved somewhat, on-exchange processing should be regarded as the best practice model for the industry, where coverage and confirmation rates remain well in advance of OTC processing, greatly reducing the risk of error and ensuring certainty of execution and performance.
- **Efficiency** - For those standardised OTC derivatives that have already been accepted for clearing, the availability of trading and clearing would add **further efficiency** to the total execution process.
- **Liquidity and Transparency** - Standardised exchange-traded derivatives may benefit from higher **liquidity**. For benchmark exchange products such as NYSE Liffe's Euribor Future Eurex's Bund Future or NASDAQ OMX equity index futures, up to half the liquidity of the contract is provided by specialist proprietary trading firms, a source of liquidity not available in OTC markets where

inter-bank business predominates. This helps to ensure **tight bid-offer spreads** and **deep liquidity**. In contrast with some OTC markets, this price discovery and transparency is available to all market users, and there is no need to access it via brokers or other intermediaries. It should be noted that further transparency through exchange trading has also been suggested by the European Parliament in its report about 'Derivatives Markets: Future policy actions', where they suggested that all financial derivatives that concern public finances in the EU (including sovereign debt of members states and local administration balance sheets) must be standardised and traded on exchange or other regulated trading platforms in order to promote transparency of derivatives markets for the public.

- **Risk Management** - Enhanced liquidity has important risk management benefits, ensuring that markets remain tradable during crisis situations, particularly if market participants default and positions need to be unwound. Indeed, liquidity confidence in a crisis situation is an essential pre-requisite of safe central clearing, and exchange-traded markets increase the confidence with which products can be cleared and risk managed.
- **Benefits for users** - The increased liquidity created by moving these contracts on to exchanges will benefit users, particularly buy-side participants. If these benefits are recognised, it is recommended that measures for moving sufficiently liquid markets to such venues are considered by public authorities, noting the previous European Commission and G20 statements on the preference for exchange trading.

In terms of **limitations**, we would like to highlight that non-standardised contracts are not suitable for central order book trading, and certain standardised contracts may not be liquid enough. We see the question as not whether all contracts should be moved to exchanges, but whether the migration of certain benchmark contracts to exchanges would increase liquidity further and decrease risk further, particularly in crisis situations. In addition, it has been noticeable, in the energy markets in particular, that certain contracts that have begun as "cleared"-only contracts have migrated into exchange-traded products after a period of time.

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

FESE members believe that most products with a high degree of standardisation as well as those products that are eligible for CCP clearing would benefit from/be suitable for exchange trading. With regards to specific products:

- **CDS** - Given the growing level of standardisation in CDS, trading on organised venues could positively contribute to enhancing liquidity and efficiency in this market. Although exchange trading of certain CDS products might not be achieved immediately as the industry is still working towards the removal of certain barriers related to restructuring events, some CDS products can already be traded on exchange.
- **Interest rate swaps (IRS)** - Although we understand the need for particular hedges and tailor made solutions by some users, there are certain interest rates types that have achieved a high degree of standardisation and that could be further standardised e.g. on specific dates. Further clarity about these products would help identifying those with a potential for exchange trading (national regulators and/or Bank for International Settlement could be useful in this sense). It should also be noted that there is already successful electronic trading of interest rate swaps in place which could possibly be expanded through further standardisation.
- **Commodity products** – For many commodity products, the nature of the underlying makes it difficult to create a standardised product, but this does not mean that standardisation efforts should not be undertaken.

- **Equity derivatives** – Equity derivatives have the broadest and most diverse user structure of all OTC derivatives, and would benefit from organised trading once standardisation is sufficiently pursued.

**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.**

Increased transparency associated with exchange trading may increase liquidity for all standardised products or products that can be standardised.

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

Regulatory action to incentivise CCP clearing of standardised/eligible products could represent an indirect incentive for further standardisation and trading on organised platforms, as products cleared through a CCP are likely to be eligible for trading on organised platforms. It should be noted that for CDS the extent of standardisation has been increasing for a number of single names, driven by the move to CCP clearing for such instruments (standard roll dates, coupon levels, etc). Certain single names have already successfully migrated to CCP clearing.

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

Although we cannot provide an exact figure or liquidity target, we believe that a good measure of liquidity could be the replacement cost of a position. The level of the replacement costs would vary depending on the derivative product as well as the desired size/economic exposure.

**Assessment of characteristics/level of standardisation that OTC derivatives have to meet to be considered eligible for trading on an organised trading platform**

**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?**

Yes. FESE believes that for a contract to be traded on an organised trading platform, the following characteristics have to be met: standardisation, general size of the underlying market, liquidity, the ability to value and settle contracts (e.g. through application of reliable, robust and transparent reference prices), the number and diversity of potential participants allied to customer demand and the need for the quality of deliverable<sup>2</sup>.

**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 products cleared through a CCP are likely to be eligible for trading on an organised platform, CCP clearing is not a pre-determining factor for a derivative contract to be traded on an organised market. For example, the ICE group offers an electronic platform for the trading of a large range of bilateral OTC energy contracts which although standardised are not CCP cleared. For certain contracts, the use of trade repositories, in addition to on-exchange electronic platforms, would provide adequate transparency for regulators.

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<sup>2</sup> This could be the basket of bonds deliverable from which the cheapest to deliver gives the basis for pricing the exchange-traded bond derivative, while for a commodity derivative such as a copper future it could be acceptable producers, brands and chemical purity of the metal.

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

Contract fungibility (in CESR's terms of contracts being fully substitutable) is in practice needed for contracts to be traded on an organised trading platform, and is certainly needed where trading is conducted in anonymous fashion. Full fungibility across different execution venues would require the contracts traded on each venue to have identical legal terms in every respect and would limit innovation, competition and choice for end-users.

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

As indicated in Q9, FESE members believe that most products with a high degree of standardisation as well as those products that are eligible for CCP clearing would be suitable for trading on an 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 difficult to quantify.

**Concept of 'exchange trading' in the context of OTC derivatives**

**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.**

Although there are substantial differences between equity and derivatives markets, there are some general characteristics that these markets share. The main difference between the equity markets and derivatives markets in relation to the paragraphs referenced is that in equity markets, OTC trades are by definition eligible to be traded on RMs, MTFs or SIs. A central element in MiFID is that a certain kind of trading (i.e. multilateral) can only happen on a certain kind of venue (i.e. RM or MTF). SIs are for bilateral trading, and equity OTC is defined in a Recital in Level 1 as an exemption from the transparency rules of SIs. It is also relevant to note that in practice, the MiFID venue structure for equities has not worked well: OTC accounts for 40% and SIs only 2%. The reasons for that are not relevant to the current consultation, but what is relevant is that the application of the MiFID venue structure – which applies to all asset classes – has proven to be problematic in the equity space. The most important issue that we expect the MiFID Review to tackle is to ensure that all identical kinds of trading are subject to the same rules.

Against this background, in the derivatives space, Paragraphs 86 and 87 are relevant but have to be revised because as they currently stand they combine two different sets of issues: (1) the characteristics of trading that has to happen on a RM or MTF and (2) the regulatory requirements that are imposed on RMs and MTFs. The reference to 'multilateral trading' is a part of (1), whereas transparency, access, order execution system, rules, and surveillance are part of (2). This distinction is important because this is exactly one of the areas of MiFID that will likely be improved in the MiFID Review, i.e. clarifying what kind of trading has to happen where. Any lack of clarity in this regard could lead to a perverse situation where a certain kind of trading might avoid the rules of MiFID by not applying the requirements of MiFID. We should also add that the criterion of 'multilateral trading' should be clearly defined and not include OTC trading because the two types of venues (RM/MTF vs. OTC) are subject to very different rules and it has to be clear which regime applies to any given trading.

Subject to our comments above, we believe these are rightly covered in paragraph 86 and 87. We believe that “exchange trading” in derivatives should only refer to RMs and MTFs (‘organised venues’) and that the obligations that this trading is subject to should include nondiscretionary and transparent rules, objective criteria for the efficient execution of orders, non-discriminatory access, authorisation/regulation and monitoring by competent authorities, operational resilience and surveillance of compliance with the organised trading venue’s rules.

**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.**

FESE believes that regulated markets and MTFs have the best ability to meet the indications of the G20 in terms of improving the transparency in the derivatives markets, mitigating systemic risk, and protecting against market abuse. These are the venues that comply with requirements and characteristics in paragraphs 86 and 87, in particular with regards to the multilateral execution of orders, which is indeed inherent to Regulated Markets and MTFs,

#### **Regulated Markets, MTFs, Systematic internalisers and Crossing systems**

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

No, as mentioned in Q18, although there are substantial differences between equity and derivatives markets, there are some general characteristics that these markets share. In the equity space, the SI regime is exclusively for bilateral trading and is not subject to most of the requirements referred to in paragraphs 86 and 87. In the derivatives market, we believe these requirements are rightly covered in paragraph 86 and 87 and Regulated Markets and MTFs are the only venues that comply with them. Systematic Internalisers do not comply with those requirements. In addition their success has proven very limited in cash equity markets, where they represent merely 2% of the cash equity market, 40% of which is still traded OTC<sup>3</sup>. Therefore the derivatives venue structure should be built on RM/MTFs on the one hand and OTC trading on the other hand.

**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, we do not think that the current or any potentially revised SI-regime would be able to provide the benefits of ‘exchange trading’ described in the paper, as Systematic Internalisers do not comply with the characteristics and requirements described in paragraphs 86 and 87. The SI regime is by definition for bilateral trading (on own account) and is subject to limited transparency requirements in equities and some execution system and access rules, hence it would fail to achieve the goals attached to bringing more OTC derivatives to organised trading. Even with any changes to the transparency rules, the SI regime would never be able to provide the benefits of exchange trading.

**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”?**

The most important improvement that we expect the MiFID Review to tackle is to ensure that all identical kinds of trading are subject to the same rules. Currently, at least some BCNs in the equity space seem to be doing the same kind of business as RMs and MTFs while being subject to (significantly less stringent and more limited) OTC rules. Applying the same principle to derivatives, we think that any kind

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<sup>3</sup> Figures based on FESE EEMR, Markit Boat, Thomson Reuters and CESR consultation paper on Equity Markets (CESR/10-394)



of trading that has the same functionality should be subject to the same rules. If there are to be any crossing networks in the derivatives space, they should fulfil all the requirements for multilateral trading included in MiFID - i.e. they should be considered as MTFs – and be subject to, for example, fair access and equal treatment of clients, need for transparent and non-discretionary rules and procedures for order execution, application of pre- and post-transparency requirements and market surveillance. These critical obligations are already imposed on Regulated Markets and MTFs and any other trading with a similar multilateral function should be subject to the same.

**Other electronic trading facilities: the US case (“swap execution facilities”)**

**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 is difficult to answer this question as the details of the US legislative proposals are being discussed and drafted by the US authorities. However, FESE members agree that global consistency is necessary to avoid regulatory arbitrage across jurisdictions. The European Parliament resolution on derivatives<sup>4</sup> underlined the need for the Commission to coordinate its actions with Europe's partners as far as possible as well as the importance of avoiding regulatory arbitrage through inadequate international coordination.

**Need for MiFID change**

**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?**

We refer to our comments above under Question 18, where we noted that the Paragraphs 86 and 87 are relevant but have to be revised because, as they currently stand, they combine two different sets of issues.

With this caveat in terms of the structure of these paragraphs, we agree that the criteria mentioned in Paragraph 86 and 87 are amongst those that CESR should apply in its further analysis. For the reasons explained above, CESR should endorse the requirements included in paragraph 87 of the consultation paper: non-discretionary and transparent rules, objective criteria for the efficient execution of orders, non-discriminatory access, authorisation/regulation and monitoring by competent authorities, operational resilience and surveillance of compliance with the organised trading venue's rules.

**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.**

As mentioned in Q24, CESR should also look at other key criteria such as those included in paragraph 87: non-discretionary and transparent rules, objective criteria for the efficient execution of orders, non-discriminatory access, authorisation/regulation and monitoring by competent authorities, operational resilience and surveillance of compliance with the organised trading venue's rules.

All regulated venues trading on-exchange OTC derivatives should comply with those characteristics. The objective of the G20 and the European Union is to improve the transparency in the derivatives markets,

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<sup>4</sup> European Parliament resolution of 15 June 2010 on derivatives markets: future policy actions (2010/2008(INI))



mitigate systemic risk, and protect against market abuse, which would not be achieved when requiring fulfilment of rules in paragraph 86 only.

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

In addition to the efforts made by exchanges to promote transparency as well as fair and efficient trading, we are not aware of any market-led initiatives promoting ‘exchange trading’. Regulators’ efforts to establish a mandatory regime or an incentives-based on-exchange trading regime would enhance improvements in liquidity, price formation, transparency, risk management and confirmation rates.

**Assessment and policy views on ‘exchange trading’: Incentives**

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

As mentioned above, CCP clearing of standardised/eligible products could represent an adequate incentive for further standardisation. In order to incentivise CCP clearing, it is legitimate to apply lower capital charges to CCP cleared products to reflect the reduced risk implied.

**Assessment of existing market-led and regulatory initiatives promoting exchange trading**

**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.**

Generally, all standardised OTC derivatives should be incentivised to be traded on organised venues. The regime of incentives should be reassessed by regulators on a regular basis and a mandatory approach taken if the incentives approach does not result in more trading of OTC derivatives on organised venues.