



EP/AGA- n° 2753\_08/Div.

Committee of European Securities  
Regulators (CESR)  
11-13, Avenue de Friedland  
75008 Paris

Paris, 16<sup>th</sup> August 2010

## **AFG RESPONSE TO CESR'S CONSULTATION ON STANDARDISATION AND EXCHANGE TRADING OF OTC DERIVATIVES**

*Ref.: CESR/10-610*

The Association Française de la Gestion financière (AFG)<sup>1</sup> welcomes CESR's consultation on *Standardisation and exchange trading of OTC derivatives* and would like to thank CESR for the opportunity given to express the point of view of the French asset management industry and more generally of the buy-side on the subject. Indeed, it is important to stress that all parts to the business should be given equal attention in the current debate.

OTC derivatives serve a vital role in financial markets, therefore the objective is to reach a comprehensive regulation that lowers risks, facilitates global monitoring and promotes transparency without unintentionally harming the flexibility and economy of the products, especially those used for hedging and risk management.

---

<sup>1</sup> The Association Française de la Gestion financière (AFG)<sup>1</sup> represents the France-based investment management industry, both for collective and discretionary individual portfolio managements.

Our members include 411 management companies. They are entrepreneurial or belong to French or foreign banking or insurance groups.

AFG members are managing 2600 billion euros in the field of investment management, making in particular the French industry the leader in Europe in terms of financial management location for collective investments (with nearly 1600 billion euros managed from France, i.e. 23% of all EU investment funds assets under management), wherever the funds are domiciled in the EU, and second at worldwide level after the US. In the field of collective investment, our industry includes – beside UCITS – the employee savings schemes and products such as regulated hedge funds/funds of hedge funds as well as a significant part of private equity funds and real estate funds. AFG is of course an active member of the European Fund and Asset Management Association (EFAMA) and of the European Federation for Retirement Provision (EFRP). AFG is also an active member of the International Investment Funds Association (IIFA).

Please see our detailed responses below:

***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?***

In AFG members' view, the key objective should be to push for the standardisation of the processes (matching infrastructure, trade repositories, CCPs, collateral, clearing, settlement delays...) and to require the standardisation of the products whose volumes and maturity would justify it. Electronically-dealt transactions should see their use increased and matching delays should diminish and standardise. Down this road, the asymmetry between sell-side and buy-side would seriously decrease.

The recommendation to take regulatory action to make the use of electronic confirmation systems mandatory should be dealt with caution. Indeed, higher use of electronic confirmation systems is desirable as it reduces operational risk, etc, however sometimes the cost may be prohibitive, especially when the market segment is not mature...

Globally we agree with the CESR's assessment of the degree of standardisation of OTC derivatives, except on the standard legal definitions and availability/use of Master Confirmation Agreements.

Indeed, our members are acting through different vehicles and therefore the legal documentation still needs to be able to be in line with specific requirements. Also, it should be taken into account that several standard documentations are in use: ISDA Master Agreements, but also others such as European Master Agreement. One point to be raised here is that we are still very far from the harmonisation of the insolvency law between EU members!

Moreover, a number of our members have stressed that it clearly appears in some cases that the practice is far away from standard terms that could be accepted by both buy-side and sell-side. For instance, some groups have implemented a standard framework for trading derivatives with negotiation of specific clauses for the confirmation which are difficult to agree upon with the sell-side.

Another example is the CDS Isda Matrix standard terms where AFG issued a standard side letter to be added to the Isda Matrix terms : unfortunately this side letter cannot be referenced in the current DTCC system used for CDS electronic confirmation, showing that standardisation of legal terms needs to be coordinated with standardisation of confirmation process.

***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?***

Our members are of the opinion that standardisation of OTC derivatives should be explored mainly for high volume transactions in mature markets such as CDS, IRS and FX trades.

However, even for this type of OTC derivatives, it is important to keep enough flexibility for trading outside the standardised terms.

For instance, CDS are the most standardised instruments according to the CESR consultations but sometimes flexibility is needed when trading credit derivatives instruments:

- When CDS are traded in investment/mutual funds, not all assets can be deliverable following a credit event for regulatory reasons (such as loans)! Funds still need to have bespoke legal confirmation to take into account this legal constraint.
- For accounting reasons, it may be important to have flexibility in CDS maturities (negative basis trades for instance) which implies being able to trade CDS not only the 1y – 3y – 5y -7y – 10y standard maturities.
- For insurance companies under the current Solvency II projected framework, CDS having the Restructuring clause as Credit Event allow a capital release when traded for hedging purpose. As US standard CDS does not cover Restructuring, an insurance company still needs to keep the possibility to trade non standard CDS (i.e. with Restructuring in the US).

Our members are therefore against any obligation to trade only standardised OTC derivatives.

There are also some specific OTC transactions which will never be standardised such as the equity derivatives trades in Structured funds (French “formula funds” for instance).

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

We agree that a greater standardisation is desirable. The goals of standardisation should be: facilitate speed of negotiation and execution of trades via minimal legal and operational effort once a standard is in place, increase price transparency pre-trade, increase post-trade efficiency (confirmation, settlement, valuation, trade life-cycle management).

However, as mentioned before, it should be allowed to continue to trade bespoke OTC transactions outside standardised terms.

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

Regulators could impose in the future further legal standards after consultation of sell-side and buy-side participants. Regulators should set targets via the definition and use of Key Performance Indicators: regulators in Europe should work hand in hand with regulators

around the world (in particular with US regulators who have already started to impose standards) so that common standards and targets are set world-wide.

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

Widely differing insolvency laws and pieces of legislation by country are preventing legal standardisation; so regulators should try first to further unify legislation across countries.

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

Priority should be given to the standardisation of the processes (please see our answer to Q1).

Also, efforts could be useful on certain elements such as legal/contractual terms and asset classes for which standardisation seems easier to implement: CDS, IRS, FX derivatives.

***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.***

Our members are of the opinion that electronic confirmation systems should be mandatory only if they can take the bespoke trades into account (by letting for instance the ability to insert term sheets in the electronic system).

We recommend again transatlantic coordination so as not to impose different standards!

Access to electronic confirmation systems should remain free or very cheap for the buy-side which does not have the means of the sell-side.

Buy-side would still have to pay to get their systems up and ready for sending required information to electronic confirmation systems. For instance, one of our members assesses the cost to upgrade their OTC systems and processes to enable electronic confirmation on most asset classes (not just CDS and IRD) to a few million euros! Asset managers too need a period of adaptation to implement IT changes.

***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?***

A good functioning of markets implies easy access to a satisfactory level of liquidity (size/price range), whatever the market conditions. In this respect, the use of electronic trading platforms for derivative products is highly desirable, as they offer a panel of choice on the most standard derivative products. However, the limit of these tools lies in the necessary adaptation of certain contracts to specific needs. The reinforcement of transparency and safety

on this kind of transactions requires to adapt the provisions related to the obligation of central clearing and to standardise practices as regards bilateral collateralisation.<sup>2</sup>

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

In our members' view, the sectors that would benefit from (more) exchange trading are first IRS, then CDS.

***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.***

Exchange trading coupled with increased price transparency on IRS and CDS would probably increase liquidity on such markets.

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

The amount of legal documentation to be signed for a specific product to be added to trading on an organised platform could be an obstacle (at least in the timing).

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

It is difficult to set a rule to measure the level of liquidity. An indicator such as the average daily volume compared to an underlying asset equivalent could be tested.

***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. As said before, the use of trading platforms should not prevent trading bespoke bilateral OTC derivatives.

***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.***

No, availability of CCP clearing is not an essential pre-determining factor for a derivatives contract to be traded on an organised platform.

---

<sup>2</sup> AFG agrees with the point of view expressed in the Report on Derivatives released in June 2010 by Paris Europlace (AFG and its affiliates are active members of the Derivatives Paris Europlace Working Group)

What matters most is the easiness of confirmation and post-trade processing of the contract once traded on an organised platform.

***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 is preferable, in particular for position unwind. The most important factor to achieve fungibility across different execution venues is that legal terms should all be the same. This is where regulators could have a role to play by imposing to all execution venues that contracts traded on each platform are done under the same legal terms.

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

The early implementation of electronic confirmation for CDS and IRS will probably ease the trading of such instruments 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.***

Our members cite CDS and IRS: the use of organised trading platforms for such instruments has already started, but could be extended to more participants if post-trade processing is eased. There could be a beneficial impact in terms of bid-ask spread reduction and transparency.

***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.***

No opinion.

***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.***

Public pricing is a very important topic and market fragmentation in the post Mifid environment has had some adverse side effects on pricing.

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

The SI regime is not one of the Mifid’s successes. We doubt it could be relevant for OTC derivatives.

***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?***

Please see Q20.

***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”?***

It is desirable to create a fourth “Mifid box” for BCNs , but we are not sure how alike they are in terms of transparency with the “organised trading venues”.

***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?***

We believe in-depth analysis is needed. Similar regimes would leave no place to regulatory arbitrage; however the two markets are different (for example: voice trading...).

***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.

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

None we are aware of.

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

Several ideas were advanced, but none is backed by a solid study: penalties in the calculation of the counterparty risk ratios, capital incentives, regulatory fees...

***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.***

Greater trading of standardised OTC derivatives on organised venues is highly desirable. However, any mandatory initiative should be cautiously examined as for unintended effects as well as for “creative” bypassing.

If you need any further information, please don't hesitate to contact myself at +33 1 44 94 94 29 ([p.bollon@afg.asso.fr](mailto:p.bollon@afg.asso.fr)) or Eric Pagniez, at +33 1 44 94 94 06 ([e.pagniez@afg.asso.fr](mailto:e.pagniez@afg.asso.fr)) or Adina Gurau Audibert, at +33 1 44 94 94 31 ([a.gurau.audibert@afg.asso.fr](mailto:a.gurau.audibert@afg.asso.fr)).

Sincerely Yours,

(signed)

Pierre Bollon