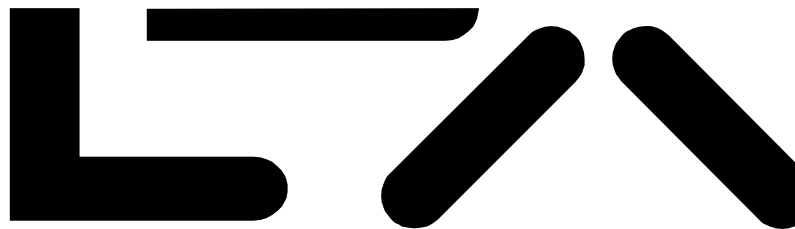


X-pand into the Future



Eurex

Position paper

CESR

Consultation Paper

Standardisation and exchange
trading of OTC derivatives

16 August 2010

I. General remarks

Eurex welcomes the opportunity to respond to CESR consultation paper on standardization and exchange trading of OTC derivatives.

We congratulate CESR on the extensive research performed in preparation of this consultation paper. The issues at hand are indeed complex, many of those initially requiring defining terms, scope and statistics and we are happy to read that our own research has been helpful in this regard for CESR. In the cited discussion contribution of Deutsche Börse Group¹, we laid down a blueprint towards improved market integrity and transparency and the reduction of systemic risk in derivatives markets following the financial market crisis, one core component thereof being trading on organized markets. We are very glad to see that a number of recommendations made therein have been picked up in the current regulatory discussion, and we look forward to further supporting our customers, market participants and regulators on the way towards a more resilient European financial market.

Being one of the world's leading derivatives exchanges and the leading clearing house in Europe, Eurex AG and Eurex Clearing AG respectively have worked for years now to provide a venue of integrity for trading and managing risk. As such, exchanges and clearing houses are the venues of choice when the market looks for price information, liquidity, equality in access and operational efficiency for trading and clearing, under the umbrella of strict rules, regulations and supervision. These benefits of exchange trading and subsequent central clearing have proven of utmost value during distressed times of the recent financial markets crisis. For many asset classes, it was exchanges that delivered price information and execution possibility for investors. Equally, it was Central Counterparties (CCPs) which managed unwinding positions of defaulting market players, while no CCP defaulted as a result.

Hence, due to lessons learned from the financial market crisis, there is a regulatory and political will for more transparent OTC derivative markets, better management of inherent risk, and more trading of OTC derivatives on organized venues. The ultimate goal of these measures is to make the markets more resilient and not to let another crisis happen when taxpayers are the "payers of last resort" to finance bailouts of defaulting firms. We have been following with great interest the US regulatory approach to address these issues which are, in terms of timing, ahead of the European debate. The USA have chosen a comprehensive, mandatory approach to central clearing and organized trading of what is declaredly yet to be defined by the SEC and the CFTC as standardized, alongside with several other very far-reaching measures to make their markets more resilient and resistant to crises. As derivative markets are global in nature, the greatest challenge for regulators will be to coordinate regulatory measures across the globe in order to prevent regulatory arbitrage.

We note that CESR seems to believe that more organized trading of OTC derivatives does not need to be mandated at this stage. As regards standardization, views are being collected how to foster a higher degree of standardization, a process which can take time. CESR notes as well that the need for contracts to be standardized is a pre-requisite for contracts to be traded on organized venues. So it seems unclear how to achieve the goal

¹ The Global Derivatives, Market - A Blueprint for Market Safety and Integrity, Deutsche Boerse Group, 2009

of more organized trading of OTC derivatives if there is no determined and clear starting point in terms of standardization in the first place.

This being said, we believe that only a mandatory approach will be able to achieve the G20 request that "all standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate". This mandatory approach should be defined as a clear roadmap of complementary measures towards more standardization of OTC derivatives and more OTC derivatives trading on organized venues:

1. A clear step-by-step plan should be defined by the future ESMA to achieve more standardization of OTC derivative contracts since so far industry initiatives have not delivered. Focus on asset classes is recommended as different elements of standardization may be required for different asset classes. There should be a clear set deadline until when standardization per asset class needs to be achieved.
2. ESMA should define a deadline until when standardized asset classes will have to be migrated to trading on organized venues. The term "organized venues" encompasses Regulated Markets (RMs) and Multilateral Trading Facilities (MTFs), which ensures that competition is provided for organized derivatives trading.
3. A mandatory post-trade transparency regime for standardized OTC derivatives is needed, which would support transparency in derivatives markets in overall terms. As regards pre-trade transparency, a method of price discovery needs to be in place, as already provided by derivatives exchanges, for exchange products and OTC look-alikes². There needs to be a shift from the trend for both pre- and post-trade transparency seen so far, namely a race-to-the-bottom to some extent for even less transparency. That is, some derivative exchanges provide full or delayed non-disclosure facilities to their customers post-trade in order to encourage order flow from OTC markets to the exchange-traded environment.
4. A straightforward and tight regime for mandatory central clearing of standardized OTC derivatives should be established, with higher capital requirements for those contracts that are non-CCP cleared. In this regard, the scope of products and degree of standardization could be the same for the trading and the clearing layer.
5. The remainder of OTC derivatives, i.e. non-standardized and non-CCP cleared, should be reported to trade repositories.

Unless EU regulators implement a mandatory approach to achieve the G20 goals for more resilient and transparent OTC derivatives markets, no true paradigm shift will take place. Even worse, regulatory arbitrage will arise as market players will escape the stricter rules in the US by conducting business in Europe where a lighter-touch treatment would be in place.

Please find our detailed comments below.

² See also the DBG position paper to CESR consultation on non-equity markets transparency, June 2010.

2. Detailed Comments

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 broadly agree with CESR's assessment.

However, there are a number of OTC equity derivative transactions that are exchange "look a like" transactions. These tend to involve buy side (particularly hedge funds) firms with sell side flow desks. These OTC products should be put subject to same rules as exchange products in terms of trade transparency, reporting, supervision, etc., in order to preserve a level playing field between exchanges and OTC.

Further, in relation to para. 44, the low degree of automation of equity derivatives can also be explained differently.

OTC equity derivatives have the broadest and most diverse user structure of all OTC derivatives as equity derivatives have been used for some time by many buy side firms including insurance companies as well as traditional and alternative asset managers. As a result, most of the sell side firms have developed over time bilateral master agreements with their broad user base. Additional complexity emerges as equity derivatives are largely "local products" driven by the underlying equities market. So, unlike in credit market, there are for the same product different ISDA master agreements for Europe, US, Asia ex Japan and Japan. Furthermore, there are different versions for dealer-to-dealer and dealer-to-client trading.

As a result, legal standardization of equity derivatives is a much more difficult task and should therefore be led and driven by regulators as a priority. Once the legal standardization has been accomplished, most of the OTC-products themselves are close to exchange products (product standardization) and can therefore be served well by clearing services (process standardization) and trading on organized platforms.

This achievement would be most beneficial to the financial industry but also to the general public as these days most of the pension and mutual funds use also derivatives as risk management and return enhancement tool.

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?

In general we agree with CESR's assessment.

As regards other elements to be considered we note that the need for non-standardized, bespoke products exhibits a "pull" demand and a "push" supply. Pull means there is a real need by the buy side or corporates for tailor-made products as standard products do not fulfill their needs. At the same time, there is a big push supply of products by the sell side, creating appetite for those bespoke products, which appear to be very profitable. It is fair to assume that the effect of the "push" is much bigger than the original "pull" effect.

A good example in that aspect is the German retail market for warrants, which is mostly OTC arranged by a push supply, shifting any potential retail interest in options away from the regulated derivatives markets towards bank products which are not centrally cleared, hence with all the associated counterparty risk for retail investors.

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

In general we agree with CESR's assessment. The goal of standardization should be to contribute toward greater transparency for both pre-trade transparency for execution purposes and post trade transparency for risk management purposes.

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

Industry and regulators should agree on the initial cornerstones to kick start the initiatives and clearly define a roadmap and timeline for a mandatory approach towards standardization and organized trading of OTC derivatives. This could be done in joint working groups of regulators and industry representatives where also technical details are elaborated, such as for example CESR Post-Trade Transparency Working Group.

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

The regulators need to consider ways in which they can ensure that all parts of the community are working together to remove obstacles with respect to greater standardization as the greatest obstacle may be vested interests.

Not many market participants have a natural interest in standardization and the resulting transparency and liquidity, as this will likely imply a change in profits and trading landscape in comparison to the status quo. Hence, it will be a difficult task for the regulators to strike the right balance between the individual profit maximization motivation and the interest of having a fair, open, transparent and efficient market place.

Thus, the obstacles to standardization are mostly driven by vested interests and will not be overcome unless regulators force standardization by regulation.

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

In general Eurex suggests to focus on b) as different elements of standardization may be required for different asset classes.

We suggest starting with equity derivatives as they are least standardized, but have the most widespread usage, in particular by buy side firms such as pension funds, insurance

companies and asset managers. On the other hand, credit indices are already fully standardized and could be among the first asset classes that could be moved onto organized trading by regulation. Further, while 'regular' interest rate swaps require further standardization, there are also so called 'IMM' date swaps (International Monetary Market date swaps which coincide with futures expiration dates) and constant maturity swaps, which, while not contributing the largest volume of business in this area, are already sufficiently standardized to trade on exchange and could act as good yield curve price indicators to the wider market as 'benchmark' type instruments that the more bespoke market could revolve around.

In order for tangible results to be delivered, ESMA should define a clear roadmap per asset class to achieve standardization by a defined deadline.

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.

Unfortunately, we do not see ourselves in a position to provide this estimate and consider that it might be helpful if the European Commission would include this issue in its planned MiFID Review Impact Assessment.

As a general remark, mandatory use of electronic confirmation systems is indeed desirable.

Any electronically confirmed OTC trade would fit to either be channeled to a clearing house and/or data warehouse, which would support transparency of OTC markets.

Therefore, a mandatory electronic confirmation supports trade warehouse /clearing house registration which serve the ultimate goal of monitoring outstanding systemic risk.

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?

In general we agree with CESR's assessment.

In relation to para. 77, we note that the reason that OTC markets can be more innovative is that it "just takes two parties" to design a new product. In contrast, exchanges, as neutral market place operators, need to create at the launch of a product a broad interest among different user groups with different trading motivations for a product to take off. That is obviously a very difficult task to perform, especially as those participants which already trade a "look a like" product OTC, often have no interest to support the exchange product. Accordingly, many exchange products do not generate enough seed liquidity and fail. This implies also that exchanges can only list products once they have developed through the early stages of product innovation and have become of interest to a wide user base. In this sense, the on-exchange and OTC market are complementary to each other.

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

In general, all sectors would benefit of exchange trading. In terms of products, there are minimum requirements in terms of user base as discussed above.

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.

As regards overall market transparency, it is in any case very difficult to imagine any asset class/sector which would not benefit from increased transparency associated with exchange trading. Obviously, this does not mean that all market participants would favor transparency. However, at the same time, opacity causes also many potential market participants not to enter into a specific market, e.g. market makers feeling uncomfortable to quote in the order book as opaque OTC market in essentially the same product exists.

As regards trade transparency, it is our understanding that there is a widespread recognition of the need for exceptions from transparency for very large transactions which could not be arranged in a fully transparent manner, as the process of seeking a counterpart for a very large trade would immediately move the market. MiFID transparency rules for equities recognize this with the large-in-scale waiver from pre-trade transparency and deferred publication arrangements post-trade.

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

As discussed above, the challenge will be to overcome vested interest in supporting OTC derivatives to be traded on organized platforms.

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

The measure that probably encompasses all of the issues with respect to size of market, bid/offer spread, etc. is the replacement cost of a position.

When measuring liquidity, one should take into consideration that different participants with different trading needs will come to different results when evaluating the liquidity of the very same market. Therefore, liquidity should be measured for different trading sizes. E.g. for a small order only the bid-offer spread is relevant. In contrast, the quality of executing large orders depends mainly on the depth of the order book.

The exchanges seek to develop deep liquid markets which address the needs of both investor groups to the extent possible. However, very large orders are mostly addressed OTC across the various asset classes in order to minimize market impact.

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?

In general we agree with CESR's assessment.

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

We do not believe that central clearing is per se a pre-determining factor for organized forms of derivatives trading, as market participants may require other value adding post trade services alongside exchange trading, depending on the asset class (e.g. CLS Group which delivers settlement service in the FX market).

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

As contract fungibility is defined by CESR, it seems rather that legal matching and netting of contracts is meant. In this sense, identical contracts should indeed always offset each other. Legal matching and netting of contracts allows automatic offset of positions and therefore reduces counterparty-, market- and operational risk. Legal matching and netting of contracts are a very important added value exchange trading and CCP clearing provides to market participants in economic terms.

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

We point out to our comments above regarding IRS and CDS index swaps. CESR have outlined in their paper most of the supporting rationale. However, this will not happen unless regulators ensure sell side support for such contracts as their liquidity/price making is a vital component.

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.

Some of examples are NYSE Liffe and CME interest rate swaps products, Eurex CDS Index products and equity options in general.

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

We recall the goal behind the G20 recommendations, which is to reduce systemic risk in the OTC derivatives markets by requiring, among others, more central clearing and more organized trading of OTC derivatives as well as registration of OTC trades in trade repositories.

We note that the defining aspects of exchange trading as laid down in para. 86 are not exhaustive and by far do not describe what exchange trading provides. What is missing are elements as listed in para. 87 that make the markets more resilient in general, concretely:

- § Non-discretionary and transparent trading rules
- § Objective criteria for the efficient execution of orders
- § Non-discriminatory access
- § Authorization, regulation and monitoring by competent authorities
- § Operational resilience, and
- § Surveillance of compliance with the organized trading venue's rules,

The characteristics describing organized trading functionalities according to MiFID as laid down in para. 87 are the minimum requirements to be fulfilled if G20 recommendations are to be met. As such, the Systematic Internalization regime does not meet a number of requirements in para. 87 and would not be sufficient to fulfill the G20 recommendations. We also refer CESR to our position paper submitted to the Consultation on CESR's advice to the Commission in the context of the MiFID Review – Secondary Markets, where we provided our opinion on the SI regime. Having said this, we disagree with para. 89. A single dealer platform does not fulfill the requirements of a multilateral trading system on the mere basis that it makes its price information multilaterally available. We very much welcome CESR's attempt to discover how single-dealer platforms should support wider price formation. Requiring single-dealer platforms to make price information multilaterally available is certainly to be welcomed as it adds transparency and value to the market, but this mere requirement does not make them multilateral trading venues, which is rather about how broad and non-discriminatory the access to the platforms is and if orders are matched multilaterally and automatically. If derivative markets are to be made more resilient for the next crisis, then all the requirements attached to organized venue trading laid down in para. 87 must be met.

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.

Any electronically operated trading platform should be technically able to make pricing information public and/or available on a multilateral basis. Even telephone brokerage could contribute to public availability of pricing information, as explained in our response

to the Consultation on CESR's advice in the context of the MiFID Review: Non-equity markets transparency.

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

No, please see our answer to Q18.

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, please see our answer to Q18.

The systematic internalizer (SI) concept failed to prove itself in practice for equities, so it is hard to imagine how this concept should address the issues that are at the core of discussion here, i.e. reduction of systemic risk and improvement in market integrity and transparency in OTC derivatives markets. For example, we note that MiFID's SI regime applies to liquid shares only, the number of which currently is 731 out of 6463 all shares admitted to trading on EEA Regulated Markets, according to CESR MiFID database as of beginning of August. Hence, the scope of instruments to which the SI regime applies even for equities is already very limited. In the debate on how to bring more OTC derivatives onto organized trading, there is even no pre-defined regulatory framework for standardization as a pre-requisite for liquid organized trading, so it is challenging how to determine the liquidity of instruments that would be eligible for trading within SIs. With this in mind, we are curious to see how the SI regime would be re-defined in regulatory terms to provide for trading in a transparent environment of integrity, with market surveillance and centralized clearing to address counterparty risk.

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"?

We refer CESR to our position paper on its Consultation on CESR's advice to the Commission in the context of the MiFID Review – Secondary Markets in relation to this question.

We are aware of the recommendation made by CESR in its Technical Advice to the EU Commission in the context of the MiFID Review published end of July to define a new category in MiFID that describes the CN business model. However, we continue to hold the view that MiFID fully sufficiently provides for a regulatory framework to describe these business models, i.e. the current provisions in MiFID are sufficient in order to cover the category of CNs and no additional definition is necessary.

In our view, CNs should be registered as either MTF or SI:

- CNs should be registered as MTF in case they allow interaction of multilateral trading interest (e.g. client orders).

- CNs should be registered as SI in case they perform bilateral matching. In that case, the definition of SI should be amended in order to provide for multilateral matching aspects.

This approach is consistent with the original MiFID categorizations and does not require an extension of MiFIDs scope to 'processes'. Instead, only a slight amendment of the SI definition is necessary such that BCNs are included in this category to allow for the concept of intermingling bilateral (today captured by SI regime) and multilateral (today: MTF and RM) matching elements.

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?

Yes, unless EU takes a mandatory approach as well, there will be room for regulatory arbitrage, see also our introductory remarks.

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?

No, these criteria are not sufficient, see our remarks to previous questions.

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 business models and characteristics of electronic trading facilities are evolving over time, a more frequent refinement of MiFID requirements would be necessary. We leave it to CESR's discretion to assess to what extent this is practicable.

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

No comment.

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

Please see our general remarks.

If any incentives would have had been at work so far, we would have seen a higher degree of standardization and more trading on organized venues already. However, the major obstacle to this goal has been vested interest of major market players to support organized/exchange trading of derivatives contracts. So unless there is a mandatory approach to standardization and organized trading of OTC derivatives, we do not see incentives that are able to deliver what is required.

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.

Yes. Please see our general remarks.

Closing remark

We are grateful for having the opportunity to share our views on this topic of consultation and remain at CESR's disposal for further discussion.

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