15 August 2010

Response to Consultation Paper: Standardisation and Exchange trading of OTC derivatives

submitted to Committee of European Securities Regulators (CESR)

by ISDA, AFME, ASSOSIM, BBA and the NSA

The International Swaps and Derivatives Association (ISDA), Association for Financial Markets in Europe (AFME), the Associazione Italiana Intermediari Mobiliari (ASSOSIM), the British Bankers' Association (BBA), and the Nordic Securities Association (NSA) welcome the opportunity to respond to the Consultation Paper published by the Committee of European Securities Regulators (CESR) on 19 July 2010 addressing standardisation and exchange trading of OTC derivatives.

I. Executive summary

ISDA, AFME, ASSOSIM, BBA, and NSA believe that risk reduction is the most important regulatory objective in relation to OTC derivatives. As such, we believe priority should be given to use of clearing for eligible contracts, of trade repositories and transaction reporting to give regulators (respectively) insight into sources of systemic risk and any abusive behaviour in derivatives business.

We support continued progress by the industry on legal uniformity, process standardisation and product standardisation in line with the commitments made by the industry. However, we do not believe that there is a case for imposing mandatory requirements or artificial incentives for standardisation of this kind. Furthermore, we do not consider that there is a case for mandating electronic trade confirmations, which would risk putting significant costs on counterparties who only use derivatives to a limited extent. In addition, we believe that product standardisation can only progress where driven by market needs and priorities.

While increased use of trading platforms will bring benefit for particular derivative product types that are suitable for such venues, we believe that mandatory or incentivized use of such platforms where such products are not suitable to their use will (a) not reduce risk and (b) will negatively affect market participants and markets in general.

As explained later in this paper, such a step could

- Undermine the ability of derivatives end users of all types to hedge risks, thus increasing overall risk in the system;

- create basis risk and earnings volatility;

- undermine market liquidity.

As the G20 recognised, it is not always appropriate for derivatives trading to take place on organised trading platforms even if the transactions have been become relatively standardised. There are many differing models for negotiating and executing a derivatives transaction and market participants should retain a choice between these different models to reflect their particular needs. In any event, the recent US "flash crash" indicates that platform trading does not eliminate systemic risks.

II. Standardisation

We agree that standardisation of OTC derivatives can have significant benefits, regardless of whether derivatives are traded on exchanges. However, standardisation is not a goal in its own right. Moreover, we do not believe that standardisation should be regarded solely or primarily as a means towards achieving a greater degree of exchange trading of derivatives.

As the consultation paper acknowledges, our Associations and the industry have a strong record of working with regulators to progressively standardise OTC derivatives in each of the ways described in the consultation paper (legal, process and product uniformity).

We strongly support continued progress by industry towards greater ***legal uniformity*** of derivatives documentation. We consider that there are strong incentives for the industry to continue to develop and use standard transaction documentation and definitions. The DTCC move to adopt Standard Terms Supplements (a form of electronic unsigned Master Confirmation Agreement for credit derivatives) is just one recent example of market initiatives in this regard. We do not believe that there is a need for regulators to create artificial incentives (such as regulatory capital incentives) for such standardisation or for regulatory action to prohibit market participants from using non-standard documentation. As the consultation paper also acknowledges, even in the case of established products there may be reasons for using non-standard documentation (for example, some clients may simply prefer to use less complex documentation or there may be special credit or other market reasons for additional or special terms). Moreover, even where international standardised documentation is available and used, there may be requirements in certain jurisdictions to use local law master agreements. In addition, any such proposal would raise significant definitional issues about what constitutes standard and non-standard documentation (and the extent of permitted variations) and the creation of a regulatory mechanism for the recognition of qualifying standard form documentation. Similar issues arise in relation to any form of mandatory regulatory incentive to use standard form documentation.

We also support continued moves towards greater ***process standardisation***, including the greater use of electronic trade confirmations. We consider that industry agreed progressive targets play a very useful role in this regard. However, we do not believe that there is a case for imposing regulatory requirements on regulated firms to use electronic trade confirmation services. The industry initiatives towards greater use of electronic trade confirmations have generated and will continue to generate very significant benefits, even if they do not achieve

100% coverage of all transactions. Indeed, 100% coverage is not a desirable or achievable goal.

A regulatory requirement of this kind would risk imposing significant costs on counterparties, in particular end users that only trade derivatives infrequently (and which would have to incur the costs of joining an electronic trade confirmation platform). It would also be entirely unsuitable for individual and private investors (e.g. family offices and private investment companies) which should not be expected to electronically confirm transactions (the costs associated would be disproportionate).

In addition, if there were to be a regulatory requirement it would be necessary to closely examine the boundary of the requirement to avoid creating restrictions on the development of new products and services, as inevitably there would have to be exceptions to any requirement (e.g. to cover products where there is no eligible service, as it may be difficult to confirm tailored or exotic products through such a service, or transactions with parties outside the EU). Regulators would also be required to define what confirmation services are eligible and, in effect, to regulate those services through eligibility criteria (including managing the resulting competition issues). Such an extended regulatory remit may not be appropriate, when the vast bulk of the benefits can be (and are being) attained by industry action.

We also support continued efforts to develop further ***product standardisation***, again where driven by market needs and priorities and taking into account product maturity, liquidity and customer requirements. Products do not need to be standardised to be liquid, as the market for foreign exchange products demonstrates.

We believe that regulatory capital charges should relate to risk and that the absence of standardisation does not, in itself, affect the degree of credit or market risk nor does it directly relate to operational risk, which can also be addressed by other means.

We also strongly agree that there are limits to standardisation and welcome CESR's conclusion that firms should retain the flexibility to customise products. However, it is not just non-financial firms that have hedging requirements that require the ability to enter into bespoke transactions. All market participants may need to create customised products and transactions for particular purposes, e.g. to pass risk between group companies. It would not be appropriate to force end-users with hedging requirements to assume mismatch risk which they may be ill-equipped to manage and which they may begin to regard as a profit centre rather than a risk management activity. In addition, restricting the range of bespoke products available will affect the ability of European corporate and other end-users to manage risk, thereby ultimately affecting their competitiveness.

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?

Our Associations broadly agree with CESR's overall assessment of the degree of standardisation in the markets referred to in paragraphs 41 to 45 of the consultation paper.

However, with respect to the summary table in paragraph 42 on pages 12 to 13 of the consultation paper, we would mention the following additional points:

- In relation to the current availability of CCP clearing of interest rate products, we do not think that it is correct to refer to CCP clearing currently being available for all forward rate agreements, caps and floors (although this is under development).

- More generally, CCP clearing is not available for all currencies or categories of products referred to in the table.

- In relation to liquidity, we also note CDS liquidity is good for on-the-run indices and these roll every six months. The liquidity diminishes for older off-the-run indices.

Q2: Do you agree with the benefits and limitations of standardisation noted above? Please specify. Can you also describe and where possible quantify the potential impact of the limitations to standardisation? Are there any other elements that should be considered?

We broadly agree with the description of the benefit and limitations of standardisation referred to in the report. However, as noted above, we believe that both financial and non-financial institutions often need to use non-standard derivatives to hedge their risks.

It has not been possible to quantify the potential impact of the limitations to standardisation.

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

We agree that the industry should continue to promote greater standardisation, in line with the industry commitment letters referred to in the consultation paper, with the aim of realising the benefits that standardisation can bring, while taking into account the limitations. However, we believe that the main focus of industry efforts should be legal and process standardisation with the goal of improving legal certainty and reducing operational risk.

Product standardisation should be driven by market needs and priorities, allowing products to evolve to meet evolving market risk management needs. As already mentioned, we believe that direct regulatory measures to force or mandate the use of standard documents, processes or products will have adverse effects.

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

We believe that the latest industry commitment letter continues to provides the roadmap for the next stage of standardisation.[1] There has been considerable progress but we believe that it is important to maintain focus on ensuring the targets are achieved as agreed, while not creating new or conflicting objectives at this time.

In addition, the process around the industry letters has successfully demonstrated that the industry (both sell-side and buy-side) and international regulators can engage in a constructive dialogue which leads to tangible results. This process continues to provide a useful framework for industry and regulators to work together, in particular because it maintains a global approach, which is essential for a global industry. We would expect that

[1] http://www.newyorkfed.org/newsevents/news/markets/2010/ma100301.html. The industry commitment letter is signed by 23 major dealers and asset managers and three industry associations active in this area.

ESMA will play a significant role in the process going forward, given the proposed powers to set technical standards for the industry.

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

In general, we consider that industry action is the best way of addressing standardisation. However, some members have mentioned issues in some jurisdiction with respect to the legal recognition of electronic confirmations and there may also be scope for standardisation on client IDs.

Intellectual property licensing restricts competition in both trading and clearing of derivatives based on equity indices. Market participants use equity indices to secure cost effective and transparent economic exposure to equity markets, including for hedging purposes. Certain indices are owned and/or only traded on a particular exchange. In addition to exchange traded activity, there is a significant OTC market in index-linked swaps and option trades. The significant volumes of index products increase the risk that index owners will either restrict trading of their index to certain execution venues and CCPs or alternatively, make licensing arrangements so cost prohibitive that only select CCPs will be authorized/ licensed to clear such transactions. Equal access to financial indices and benchmarks is vital to achieving market efficiency. As such, indices should be subject to non-exclusive and non-discriminatory licensing arrangements (with fair and reasonable fee structures) to promote diversity and competition.

More generally, regulators can encourage market services and utilities to be designed with standard process flows and standard channels of open access for interconnecting service providers.

In addition, there is clearly a role for standardisation of regulation to reduce the impact of overlapping and conflicting rules.

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

We believe that the industry should focus on the elements of standardisation most likely to be susceptible to action as outlined in the latest industry commitment letter.

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.

We welcome the growth of electronic confirmation systems, in particular their role in dealer-to-dealer trading. However, for the reasons discussed above, we have concerns about imposing an obligation on (or artificially incentivising) firms to use electronic confirmation systems. For certain clients, there may be a disproportionate cost of implementing such obligations. This is typically the case in the rates derivatives markets where the clients are often corporate end users that use derivatives relatively infrequently. It could also create issues in relation to tailored contracts which cannot readily be confirmed by those means. We believe that an industry led approach provides greater flexibility for reduction of operational risk without adversely affecting the market.

We would support a fuller and more extensive investigation into the costs and benefits of broadening the use of electronic confirmation systems.

If there were to be a mandatory requirement, we would strongly advocate limiting the remit of the requirement to fully standardised products which are traded in significant volumes, but there would still have to be wide ranging exceptions so as not to exclude (from such exceptions) large numbers of market participants which cannot effectively participate in electronic confirmation platforms and where electronic confirmation is not possible.

Additional question: Should there be greater uniformity of post-trade processes between products traded or cleared in different venues?

CESR has raised a specific additional question regarding the possible need for greater uniformity of post-trade processes between identical products that are traded or cleared in different venues.

Trading platforms are execution venues, some of which are combined with a CCP function (for example, exchanges) and some are not. For non-exchange trading platforms, the resulting transaction would either be a bilateral relationship or cleared via a CCP that is open to accepting trades for clearing that are executed elsewhere.

There are legitimate concerns that there may not be uniformity in how post-trade processes are handled for products that are traded or cleared in different ways. If post-trade adjustments or determinations could be made in different ways or with differing outcomes then otherwise identical products could perform in different ways. In particular, this would introduce an element of basis risk for parties that hedge a position traded or cleared in one venue with an apparently identical position traded or cleared in another venue, which would be exacerbated where there are multiple CCPs. For CDS, the market has generally moved to adopting a uniform determinations process for the market, avoiding such an outcome. All standard CDS trades now incorporate the 2009 ISDA Credit Derivatives Determinations Committees, Auction Settlement and Restructuring Supplement to the 2003 ISDA Credit Derivatives Definitions. Under the Supplement, the Determinations Committee (comprised of dealers and buy-side institutions) is given the authority to resolve certain issues, including the determination of whether a credit event or succession event has occurred. The determinations of the Determinations Committee are binding on the parties to the transactions. In addition, trades that include the Supplement have a dynamic effective date meaning that the period during which a credit event or succession event can occur is linked to the current date rather than the original trade date. Thus, all trades have a uniform observation period.

This process has been extended to CCPs that clear CDS which now also apply the Supplement. It is important that all the key determinations of a CDS contract are made by one body (the Determinations Committee) to ensure that trades executed with different counterparties or cleared with different platforms perform in exactly the same manner. If a counterparty or a CCP has alternative or additional contractual determination responsibilities two seemingly identical contracts will perform in an inconsistent manner. The CCPs also incorporate the operational flexibility of the original product in matters such as partial triggering. This standardisation and uniformity ensures that a market maker who sits between two OTC counterparties, two CCPs or a combination of the two has the same standard trade terms on either side.

However, there may still be some residual concern about the extent to which the emergency powers of CCPs could undermine the uniformity of outcome resulting from the application of industry-wide determinations. There may be scope for further discussions about the possible impact of these powers and the limitations on and governance relating to their use.

Nevertheless, the case for standardisation needs to be considered carefully on a case by case basis to determine whether it would add value by significantly reducing systemic risk. For example, there may be differences between the way different exchanges/CCPs and OTC documentation deal with adjustments to equity derivatives (e.g. for rights issues, capital distributions, etc.).

III. Trading on exchanges and other organised trading platforms

In this response we refer to trading on exchanges and other organised trading platforms collectively as "platform trading".

We agree that platform trading can give rise to a number of benefits, including transparency, price formation, liquidity, operational efficiency and market access. However, platform trading is not the only or best way of achieving those benefits. Indeed, many, if not all of those benefits can be attained through electronic confirmation, clearing and the use of trade repositories and/or transaction reporting to provide post-trade transparency to the market and to regulators.

Moreover, those benefits cannot be attained through platform trading where the nature of liquidity and participation in the market are not such as to support effective platform trading in a particular product. In many cases, bilateral voice trading will remain an important method of negotiating trades even if the market is able to support a level of platform trading in a product. For example, organised trading platforms may not always be deemed a suitable venue by users for executing large trades.

In any event, there is a spectrum of execution models of which multilateral exchange trading is one model. Organised trading platforms can offer a variety of differing electronic trading services to multiple participants and individual dealers also offer electronic trading services as an alternative to conventional oral trading. Organized trading platforms include exchanges, inter-dealer brokers, multilateral dealer platforms and single dealer platforms. Exchanges may offer combinations of open outcry and electronic trading. Some platforms may offer order book styles of trade while others do not. Prices on platforms may be executable or indicative (requiring a request for a firm quote in order to trade) and prices may be offered to all participants ("many to many") or only available to those approved for trading by the relevant dealer ("one to many"). These methods of trading are complementary to one another and attract different kinds of users. It would be inappropriate to seek to force all trading into a particular venue. CESR should recognise the needs of clients to be able to choose the execution method that suits them best.

For example:

- In the credit derivatives area, executable market platforms exists for a small population of liquid index products (TradeWeb, dealer pages on Bloomberg etc). Though these are available, they are not commonly used by end-users but in the inter-dealer market electronic execution platforms see significant use. Request-For-

Quotations facilities exist in platforms like Market Axess or Creditex where clients can get prices and execute electronically – but are not commonly used.

- In equity derivatives, exchanges have a long history of attracting liquidity from the OTC markets as contracts become more liquid and commoditised, and as they are naturally incentivised to do so (see B-Clear, FLEX Options and block-crossing mechanisms). Additional services are continuously added as client side demand dictates. Wholesale broker aggregation services also exist (BrokerHub, CScreen, Vectalis), with varying degrees of use

- In interest rate derivatives, TradeWeb and Bloomberg are two of the major electronic platforms for multi-dealer execution for clients and provide access to tight bid/offer spreads, while single dealer platforms also allow for price discovery and trade execution.

- The FX market was an early pioneer of modern flexible electronic trading. In particular for FX spot (where there are a limited number of parameters), multiple competing electronic platforms exist that provide clients with a wide choice of execution methods including streaming prices ("click and deal"), request for quote (RFQ), single or blended liquidity, algorithmic trading, etc.

The complementary nature of the various execution models is illustrated by LIFFE's equity derivatives market where a significant part of volume is OTC trades contributed through Bclear.

Moreover, in terms of price transparency, there is already a good level of pre-trade price transparency in the OTC derivatives market. The joint AFME/BBA/ISDA response to CESR on non-equities market transparency summarised the various avenues available.[2] These include the various platforms referred to above as well broker screens, data vendors and price aggregators. Market participants are principally institutional and professional in nature and are able to access pre-trade transparency through multiple venues and formats.

AFME's 5th Annual Market Liquidity Fixed Income Survey highlighted the continued growth of electronic trading platforms as a complementary venue to OTC/voice trading. We continue to expect future growth in these areas according to client demand and product evolution and this increase is also anticipated across derivatives sectors too. However, it is important to note the continued importance of the OTC/voice market, with investors surveyed citing the ability to trade in large ticket sizes, access to liquidity and market volatility as the primary reasons for their continued preference for OTC trading.

As the G20 recognised, it is not always appropriate for derivatives trading to take place on organised trading platforms even if the transactions have been become relatively standardised. There are many differing, complementary models for negotiating and executing a derivatives transaction and market participants should retain a choice between these different models to reflect their particular needs. Forcing or mandating the use of one particular model is likely to result in diminished liquidity for market participants.

[2] AFME/ISDA/BBA Joint response to CESR on non-equities market transparency in the context of the MIFID review, June 2010, pgs 4-12, http://www.cesr-eu.org/popup_responses.php?id=5668

The nature of the liquidity and the type of participation in the markets are critical in determining whether platform trading will be effective. Forcing a particular market into a particular mode of execution that participants have not selected naturally could lead to a sub-optimal outcome. Equity markets are not necessarily a good benchmark for derivatives because secondary trading of products is limited and in many cases non-existent, the investor base for derivatives is primarily institutional and derivatives have a much higher volume and diversity of products, including many more bespoke products. Some clients have restrictions on their ability to trade on derivatives exchange platforms.

While standardisation is a pre-condition for multilateral exchange trading, it is even more important that there is continuous liquidity and a number of participants with matching trading interests, enabling those interests to be matched without the need for an intermediary. The bond markets (which are characterised by a high degree of OTC trading) illustrate that highly standardised instruments are not a sufficient criterion to ensure trading on exchanges. In cases where there is a relatively small number of professional market participants with different risk and investment requirements, there is likely to be a natural timing gap between the emergence of natural buyers and sellers which make the market less likely to gravitate towards exchange trading. If multilateral exchange trading is forced or mandated for markets that naturally are better suited to OTC trading, liquidity will in fact be discouraged as intermediaries will no longer have the information obtained through market making which encourages them to supply liquidity. The reduction in the ability to manage risk will have consequential impacts on the costs and competiveness of corporate and other end-users of the markets.

It is also important to maintain alternative methods of negotiating or executing trades to allow for the possibility of significant drops in liquidity (such as where there is a jump in volatility). In those circumstances, market participants will wish to be able to seek out and negotiate with the available sources of liquidity on a bilateral basis. Constraints on their ability to do so will exacerbate market issues by restricting alternative sources of liquidity. For example, during the financial crisis there was a significant drop in volumes in standardised, plain vanilla exchange traded contracts.

Where the number of participants is very low (for example, for some commodity contracts), disclosing the transaction, even on an anonymous basis, would be sufficient to identify the participants in the transaction and would not result in useful market information due to the specificity of the price.

In addition, platform trading can result in decreases in order/transaction size and increased trade frequency. However, these can also be signs of an inefficient market, as they can be the result of the unwillingness of market participants to perform effective risk transfer functions. For example, on the CME algorithmic traders contribute a large part of daily volume but for the most part this liquidity is intra-day, which does not ensure overnight risk transfer in the same way as dealers in the OTC markets. Markets characterised by those features can also be more vulnerable to risks of the kind illustrated by the recent 'flash crash' in the US and the removal of human interaction can in fact may systems more vulnerable.

We support regulators having greater access to information on transactions through the use of trade repositories, central counterparties (for cleared transactions) or, in appropriate cases, transaction reporting to regulators. However, the desirability of post-trade transparency to the market as a whole needs to be weighed against the potential impact on liquidity.

We believe that it is important to allow continued scope for innovation through the creation of new products and services meeting evolving client needs.

We also consider that it is important that even where products are traded on organised trading platforms, it is still possible to trade those products on an OTC basis. Many products, including equities, are traded both OTC and on exchange. For example, large blocks of shares are currently traded OTC for a number of reasons (confidentiality, inability of exchanges to process large stakes, etc.). There would be no advantages in forcing this kind of trading onto an exchange even though shares are completely standardized and completely fungible. Similar issues arise in relation to derivatives, where large institutional participants frequently trade in large size to hedge or manage risks. These trades are an essential feature of the market but cannot be handled through platform trading.

As the UK Financial Services Authority and HM Treasury concluded in their December 2009 paper on reforming OTC derivatives markets, mandating the trading of standardised OTC derivatives on organised trading platforms is "unlikely to deliver the benefits which would warrant the costs of introducing such a policy proposal when regulatory objectives can be achieved by other means" (para 8.4).

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?

We believe that it may be appropriate to develop platform trading of products where the characteristics of the market are such as to be capable of supporting that kind of trading. The descriptions of the limitations of platform trading should include the issues associated with exchange membership and trading fees and, if platform trading were to be mandated or forced, the loss of flexibility to use bespoke products, exposure to basis risk, loss of accounting benefits and suppression of innovation and loss of risk management opportunities. Mandating or forcing products onto organised trading platforms will not increase liquidity if the nature of the market interest is not suited to this form of trading. The market will naturally gravitate to the trading model that is best suited to it.

Where platform trading takes root, it should co-exist alongside other forms of trading for particular products. Even in the context of equity markets, a large part of the trading remains OTC, without adversely affecting the overall market.

If we imagine a scenario where all products have to be traded on a regulated exchange, for example, drawbacks that market participants could see would include

- Inability to customize – If regulated exchanges are to be the venue for all OTC derivatives trading, and if regulated exchanges are to be allowed to function on a commercially-sound basis, that would imply that some very lightly traded, specialized, bespoke contracts (e.g. a very customized contract between two counterparties, at least one of which has a very specific hedging need) would simply not be traded, as being forced to provide a public venue for a contract that might only be traded once in a year, or even once ever, would mean that this would be a loss-making activity for the regulated exchange. Thus, trading activity could be limited to a subset of existing contracts, and the ability to customize contracts according to the needs of counterparties would be limited. More importantly, concentrating the market into a more narrow range of exchange-trade products could potentially increase

systemic risk, as clients would not have the ability to hedge and appropriately manage their unique risks.

- (Associated) basis risk and earnings volatility – if counterparties who wish to hedge are prevented from being able to enter into contracts that are customized to hedge the specific risks they face, they will face basis risk (a mismatch between the risks they face and the contracts they have to use), and earnings volatility, as it will be more difficult to qualify for hedge accounting treatment.

- Public Transparency – this is particularly, not necessarily exclusively, the case in less liquid markets. Market participants – particularly hedging counterparties – may be very reluctant to let other market participants see their trade information, for fear that the market could move against them. More liquid, high volume markets are often characterized by significant degrees of trade transparency. Liquidity is not a constant, however – and imposition of excessive transparency requirements – either by forcing use of a public trading venue, or by imposing post-/pre- trade transparency, can make some contracts less attractive, undermining liquidity and the risk management needs of counterparties. Please also see the attached ISDA briefing paper on this issue.

- Trade size – the unit size of OTC trades are typically larger than those on-exchange, reflecting (a) the professional nature of the market (exchanges may have a significant retail level of participation – at least for some types of instrument) and (b) the customized nature of the product (it is easier for counterparties to agree one deal, than for a counterparty to have to purchase many units of smaller-denominated exchange-traded contract, especially when it may not be possible to buy/sell enough units at any one moment, and between (the necessary) trades, the market price may move against the counterparty looking to take the position (see transparency point)

- Margin/Costs – Non-financial institutions may find the requirement to post margin very prohibitive, with consequences that have been well-publicized (increased market risk or liquidity risk, depending on whether the non-financial institution deems it in its interest to hedge; costs; earnings volatility etc).

The extent of the drawbacks associated with venues depend on the nature of the venue concerned (exchange/MTF/broker/dealer platform) – each has its own characteristics in terms of public disclosure, costs, liquidity, flexibility etc – and the precise needs of the market participants. A loss of liquidity also has implications for systemic risk.

As was mentioned in the staff report of the Federal Reserve Bank of New York, *Policy Perspectives on OTC Derivatives Market Infrastructure* (no. 424, January 2010):

"If, however, market participants are forced to migrate to exchanges and electronic trading platforms too aggressively, then dealers may find that their original costs of innovation are unlikely to be recovered from future intermediation fees. Some useful new or customized financial products may be stifled. This could imply lost opportunities for risk management and, potentially, less market liquidity. Effective opportunities for risk management are important ingredients to economic growth in the broader economy."

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

We do not believe that it is possible at this stage to identify market sectors that would be suitable for more platform trading. There are already commercial incentives for exchanges and other platforms to launch new products where they believe that platform trading would be attractive to market users. Markets will also naturally gravitate towards the optimal method of trading.

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.

We do not believe that increased transparency will generally increase liquidity. Indeed, in many cases increased transparency could threaten liquidity if it were forced or mandated.

See the AFME/BBA/ISDA comments in response to CESR's consultation on pre- and post-trade transparency for further information and comments on this issue.[3]

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

No, markets will gravitate towards the use of these platforms if they suit market participants' needs.

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

It is not possible to identify in advance a generally applicable measure of liquidity that would indicate that platform trading is feasible for all products (although some work has been done in relation to particular products, such as CDS).

Multilateral exchanges are likely to be most suited to markets characterised by factors such as a significant degree of retail participation and a relatively narrow range of product types. However, as the market for equity derivatives demonstrates, even if part of the market can gravitate towards platform trading of this kind, other parts of the market will continue to favour other trading methods.

In addition, the liquidity for a given contract can change over time. For example, CDS trades referencing the same underlying name can have different tenors and there can be great differences in liquidity depending on the remaining maturity. As the trades age, they will become less liquid. In addition, as already noted, significant changes in volatility can have an impact on liquidity.

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?

Organised trading platforms can facilitate trading in non-standardised contracts by providing bulletin board facilities allowing participants to advertise their interest in entering into particular transactions on a bilateral basis. So to that extent standardisation is strictly a pre-condition for use of an organised trading platform. As already mentioned, there is a spectrum

[3] http://www.cesr-eu.org/popup_responses.php?id=5668

of execution models which ranges from the anonymised, multilateral trading model (where standardisation is important) to OTC trading.

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.

Similarly, CCP clearing is not an essential pre-condition for the use of organised trading platforms. There are execution models where dealers bilaterally clear transactions entered into through an organised trading platform. The general shift towards greater CCP clearing of derivatives should not have the effect of precluding the use of other clearing models where appropriate. However, central clearing is essential for anonymous trading (even more so than for equities trading, because of the duration of the credit risk taken on by the counterparty to the contract).

The standardisation of contracts for clearing is a different process to that for exchange trading (see e.g. the wide range of commodity contracts cleared by Clearport and ICE OTC). It is important not to confuse these two distinct approaches.

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

Again, fungibility is not an essential pre-condition for every execution model, including those using organised trading platforms.

However, there are clearly advantages in being able to create products which reduce or eliminate basis risk between products traded on different platforms or OTC. As mentioned above, we strongly support continued progress by industry towards greater legal uniformity of derivatives documentation. We consider that there are strong incentives for the industry to continue to develop standard transaction documentation and definitions to reduce basis risk in this way.

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

In order to identify OTC derivative contracts for which there could be further developments in platform trading, it would be necessary to engage in extensive market dialogue to identify particular products where platform trading would add value for market participants and where market participants would actually make use of the trading facility. However, forcing or mandating platform trading is likely to have significant adverse effects. It could have particularly bad effects if regulators sought to force or mandate trading onto particular platforms within the EU, where the market for the particular product is more global in nature, as this risks fragmenting liquidity. Standardisation and CCP clearing are not in themselves sufficient conditions to allow effective platform trading of any product.

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.

Given that markets will naturally gravitate towards the execution model that best suits them, the fact of limited platform trading in an existing product suggests that the particular platform is not best suited for the particular product market.

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.

Paragraph 86 of the consultation paper describes a particular execution model that can be appropriate for certain markets. Some of the elements in paragraph 87 could also be descriptive of that execution model (e.g. non-discretionary rules) whereas other elements (such as non-discriminatory access or operational resilience) are statements of regulatory requirements that, as a matter of policy, could be imposed on institutions offering that trading service.

The definition of the particular execution model in MiFID could have two broad functions. The definition might serve to identify particular execution models that require additional or special regulatory treatment (as in MiFID at present). Those offering or providing those services may have to comply with defined regulatory obligations. Alternatively, it might serve to define the scope of an attempt to force or mandate trading on trading platforms of particular kinds

As already indicated, we do not consider that it is appropriate to force or mandate platform trading in any way, but if there are to be incentives (or compulsion) of any kind to use platforms then it will be important to ensure that the definition of permitted platform is as wide as possible to allow the maximum flexibility for the market to gravitate towards the execution method most suited to it (even if, on this assumption, there are to be restrictions on bilateral voice trading). Mandating or forcing trading on platforms that meet the requirements set out in paragraphs 86 (or 86 and 87) would be likely to significantly damage many product markets. Organised trading platforms should be able to offer a variety of different services, which differ from the multilateral model used by exchanges. For example, existing electronic communications networks or equivalents (such as Bloomberg or Tradeweb) allow streaming of indicative prices by dealers to clients, who can then submit requests for quote from multiple dealers and elect to trade with one of the dealers, based on the comparable quotes given. Similarly, inter-dealer brokers play an important role. This differs from the model of anonymous trading on multilateral exchanges but is an important and successful part of the market. As was mentioned in the staff report of the Federal Reserve Bank of New York, *Policy Perspectives on OTC Derivatives Market Infrastructure* (no. 424, January 2010) "[policies should support the growth and breadth of participation in ETPs [electronic trading platforms] for any sufficiently simple and actively traded derivatives".

We do not consider that there is a policy justification for "eliminating the bilateral nature of concluding trades"[4]. First, as already mentioned, it would restrict the range of different types of platform that allow bilateral trading. Secondly, we consider that it will be important to allow bilateral voice trades to continue in parallel to the growing role of platform trading, to accommodate those (many) circumstances where the use of platforms is not appropriate for the parties' needs.

[4] European Commission Communication 20 October 2009: 'Ensuring efficient, safe and sound derivatives markets: Future policy actions', page 9.

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.

There is a wide variety of pricing information that is available under existing trading models. In many cases, this includes a high degree of pre-trade transparency. See our response to CESR's consultation on transparency.[5]

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

No. CESR has recently advised the European Commission recommending that the Commission should review and clarify the objectives and functioning of the regime for systematic internalisers (Sis) as it currently applies in relation to listed equities. The SI-regime has not proved its value in relation to equities trading and therefore seems unlikely to be an appropriate model in relation to derivatives business.

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?

Not applicable.

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 unclear how the discussion of crossing networks is relevant to OTC derivatives.

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?

In our view, it is important to be clear on what objectives are to be attained before prohibiting or restricting OTC trading in the EU of any particular class of derivatives. It will not serve the long term interests of users of derivatives if they are unable to execute their transactions because other participants are unwilling to engage in platform trading, for example, because the costs of that trading or the requirements for pre- or post-trade transparency reduce liquidity.

In addition, it is necessary to bear in mind that the markets in question are global markets and there are risks that business will move outside the EU (the EU and the US are not the only places where business takes place). We believe that there should be common approaches developed through global co-operation. The EU has a particular concerns because of the larger, more developed state of the OTC derivatives market in Europe.

[5] See note 2 above.

In any event, at this stage, the detail of the US requirement remains unclear as it will depend on rule-making. It may be that the US approach will eventually allow the use of a wider variety of execution models, including voice negotiation, and in any event the US requirement will only apply to cleared derivatives and then only subject to exemptions (the final version of the US legislation as adopted differs somewhat from the description in paragraphs 101 to 104).

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?

As already noted, there is a continuum of different kinds of execution models (as in evidence in equity markets). The Commission has indicated its preference for a particular model. However, this will be suited to some markets but not others. As already noted, if there are proposals to force or mandate platform trading it would be important to have as wide a definition as possible of what constitutes a qualifying platform.

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.

This would only be necessary if it was desired to further regulate other kinds of execution model or if regulators were to seek to force or mandate platform trading.

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

With the advent of clearing, several ventures are under way to provide forums for platform trading of IRS and CDS products. Whether they are successful will depend on the extent to which they meet the needs of market participants.

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

We do not consider that there should be regulatory incentives (in particular capital incentives) that seek to promote platform trading. As we have mentioned, we consider that the key criterion is whether or not the contract will be successful on the relevant platform. The platforms themselves also need to consider whether there will be sufficient volume to justify offering the product. Imposing prohibitions or restrictions, or using artificial incentives, is likely to distort the market and lead to less than optimal outcomes particularly if there are changes in the level of liquidity in particular products over time. Incentives will be unhelpful if the clients do not wish to use a particular method of execution.

Capital requirements should focus on risks. Platform trading does not reduce credit or market risk and operational risks are better addressed by other means.

Q28: Do you believe there would be benefits in a mandatory regulatory action towards greater trading of standardised OTC derivatives on organised venues? Please elaborate.

We do not consider that it would be appropriate for regulators to attempt to force or mandate platform trading. Even where exchange platforms exist for particular products, there are legitimate reasons why market participants may wish to enter into bilateral transactions or use

other execution models such as electronic trading. It is unlikely to be possible to execute all types of business through trading platforms (particularly, large individual transactions, which require the commitment of capital). If there are restrictions on OTC trading (or artificial incentives) it will be necessary to address the resulting competition issues and the issues that will arise if there are changes in market liquidity which mean that exchange trading is no longer an effective execution model. In periods of high volatility market participants seek liquidity outside organised markets. The "flash crash" indicates that platform trading does not eliminate systemic risks and that the removal of human interaction can make systems more fragile. The current MiFID model encourages competition between different methods of execution. It would be unfortunate to move away from that model in relation to derivatives when it has been beneficial in driving innovation and other benefits in relation to equities.

The Associations

AFME (Association for Financial Markets in Europe) promotes fair, orderly, and efficient European wholesale capital markets and provides leadership in advancing the interests of all market participants. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association through the GFMA (Global Financial Markets Association). AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76. For more information please visit the AFME website, www.AFME.eu.

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The British Bankers' Association is the leading association for UK banking and financial services sector, speaking for over 200 banking members from 50 countries on a full range of UK and international banking issues. All the major institutions in the UK are members of our Association as are the large international EU banks, the US banks operating in the UK, as well as financial entities from around the world. The integrated nature of banking means that our members engage in activities ranging widely across the financial spectrum encompassing services and products as diverse as primary and secondary securities trading, insurance, investment bank and wealth management as well as conventional forms of banking.

The International Swaps and Derivatives Association, or ISDA, was chartered in 1985 and has over 820 member institutions from 56 countries on six continents. Our members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Since its inception, ISDA has pioneered efforts to identify sources of risk in the derivatives and risk management business and reduce those risks through: documentation that is the recognized standard throughout the global market; legal opinions that facilitate enforceability of agreements; the development of sound risk management practices; and advancing the understanding and treatment of derivatives and risk management from public policy and regulatory capital perspectives.

The Nordic Securities Association (NSA) represents the common interests of member firms in the Nordic securities dealers associations towards external stakeholders primarily in the Nordic market but also on European and international issues of common interest. Members of the NSA are the Danish Securities Dealers Association, the Finnish Federation of Financial Services, the Norwegian Securities Dealers Association and the Swedish Securities Dealers Association.