Confidential

To: Committee of European Securities Regulators

J.P. Morgan comments in response to the Consultation Paper published on 19 July 2010 by the Committee of European Securities Regulators (CESR) addressing standardisation and exchange trading of OTC derivatives (Ref: CESR/10-610).

Introductory Comments to Standardisation

We support the legal and process standardisation for OTC derivative contracts in all asset classes, as described in the Consultation Paper. However, we do not agree with CESR's assessment of the need for product standardisation, as discussed below.

In June 2010, ISDA provided the U.S. Federal Reserve Board with a detailed analysis of the current state of standardisation in the OTC derivative equity, rates and credit markets. This analysis is appended and details: (i) the current level of standardisation in each of these markets (legal terms, standard contracts, market practices and other standardisation features), (ii) the execution, confirmation, settlement and clearing processes, (iii) levels of available pre and post-trade transparency and (iv) additional and future standardisation initiatives currently underway/planned. We believe the Appendix demonstrates the high level of both our and industry's commitment to the enhancement of legal and process standardisation, and highlights the significant strides that we, along with the industry, have already made to increase these market efficiencies.

As referenced above, we do not believe that the standardisation of *products* is a desirable objective. While there are tangible benefits to legal and process standardisation (e.g. as a means to increase legal certainty, operational efficiency and reduce systemic risk), we support product standardisation being driven by market forces, through the interaction of supply and demand, innovation and development of customer solutions.

Moreover, we do not believe that product standardisation is a pre-requisite for any of the following and we refer you to the detailed analysis in the Appendix in support:

- for process standardisation;
- to ensure liquidity in a product; many non-standard products are highly liquid;
- for achieving electronic trading, or end-to-end straight through processing (STP) and clearing;
- for trading on an organised platform; or
- for clearing to a recognised CCP.

In this context, we emphasise one aspect which we will discuss in greater detail below: standardisation does not give rise to or equate to liquidity and therefore should not be considered as a means to facilitate liquidity; there are a large number of standardised products that are not liquid, and vice versa.

In the context of standardisation, we draw your attention to the distinction between "benchmark" and "off-benchmark" transactions[1].

The importance of "off-benchmark" transactions is discussed further in the response below. However by way of introduction, we note our belief that off-benchmark transactions enable clients to optimally manage their unique risks. We also emphasise that products may be off-benchmark yet have the benefits of full electronic confirmation, processing, clearing, and a standardised legal framework.

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?

As referenced in our introductory comments, we broadly agree with CESR's assessment of the degree of standardisation of OTC derivatives. In particular, we draw your attention to our comments above regarding the differences between legal, process and product standardisation.

With respect to section 2.3 of the Consultation Paper, we note that in relation to "Current Availability of CCP Clearing for Interest Rates," not all FRAs (forward rate agreements), caps or floors are currently available on CCPs, although that change is imminent. We also note that option products are undergoing a feasibility study at present.

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 agree with CESR's overall assessment of the benefits and limitations of standardisation and support incentives promoting the electronic confirmation of OTC derivatives for those categories where standardisation is consistent with market participant need.

However, excluding off-benchmark transactions, which can be standardised and so may be electronically confirmed, we note that there is a proportion of OTC derivatives which are customised to meet unique client needs, and as such, cannot be sufficiently standardised to warrant electronic confirmation. The proportion will vary depending on each asset class. By way of example, some interest rate products, as well as some foreign exchange products are liquid but not standardised. Financial and non-financial institutions use customised OTC products including, for example, credit and rates, for hedging their risk. Similarly smaller banks use customised interest rate swaps to hedge risk mismatches.

[1] A benchmark transaction may be described as follows:- a regularly executed transaction with many economic parameters set to acknowledged market conventions, which is standardised in legal, process and product terms; and which can typically be referenced in short hand by a benchmark instrument reference and key economic terms, such as 10Y EUR IRS: Buy or Sell, Notional, Fixed Rate, or Client Name.

In contrast, an "off-benchmark transaction" has the following attributes: a transaction with economic parameters set to bespoke terms stipulated by the relevant client (such terms are usually required to support matching specific asset/liabilities to transfer risk away from the end user). The transaction is nevertheless standardised in both legal and process terms ; leverages standard ISDA legal framework; can be processed as STP through price discovery, execution, affirmation/confirmation, submission to clearing and which may be successfully cleared by an existing rate derivative CCP despite the bespoke terms.

We believe, that in these circumstances, to require standardisation would have an inadvertent and detrimental effect on market stability and the broader economy where financial and non-financial institutions would lose the capacity to enter into products tailored to suit their unique risk profile, effectively depriving them of the ability to optimally manage their risks, potentially increasing cost while increasing risk. The OTC markets facilitate desired risk transfers, which if discouraged will leave risk in hands that do not wish to hold it and/or are unable to manage it.

We are unable to quantify the impact of limitations to standardisation, as the degree of customisation required by financial and non-financial users of derivatives is driven by the market and dependent on the micro and macro risks faced by the participants at any point in time. We also caution that product standardisation effectively equates to economic variable standardisation, which we believe is not possible: in the FX markets, for example, the precise needs of each participant are as economically diverse as the multitude of cash flows that need to be managed daily.

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

As we refer to in our introductory comments, while we are in favour of greater legal and process standardisation (to increase legal certainty, operational efficiency and reduce systemic risk), we do not believe that standardisation should always be a goal in itself. In particular, product standardisation is most efficient and effective, in our view, when driven by market forces, through the interaction of supply and demand, innovation and development of customer solutions.

We believe the overriding goal of further standardisation should be reduction of systemic and operational risk and increased legal certainty, while maintaining the ability for the market to innovate, and meet the risk management needs of financial and non-financial institutions. A high level of product standardisation, in our view, is not required to achieve this goal.

We believe customisation creates liquidity in the OTC markets and drives down costs incurred by the buy-side; conversely limiting the degree of customisation would, in our view, lead to increasing cost to the buy-side in terms of liquidity and restriction of the ability to manage specific risks. Standard contracts or "benchmark" transactions meet one type of demand from OTC market participants but we believe that by making everything a "benchmark" transaction, inadvertent and detrimental consequences result, namely a rise in systemic risk and direct costs and the loss of tailored risk management tools.

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

We strongly support international cooperation between regulators and market participants, and given the significant change taking place in the EU and the US in relation to the regulatory framework, we support further initiatives involving coordination between regulators and the industry which will help to drive the setting

of *global* targets for the OTC derivative markets. In this context, we cite the "OTC Regulatory Forum Letter[2]" as a recent example of such successful coordination.

We also refer to the Appendix which provides details of work the industry has completed to date in achieving legal and process standardisation, and we welcome continuing dialogue with CESR, particularly in light of the key role that CESR's successor body, ESMA, will play on this global issue in the future.

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

In some Member States, the legal enforceability of two separate and important processes-- electronic confirms and netting-- is not beyond doubt, a challenge which should be removed by regulatory action.

Local requirements sometimes preclude consistent EU transaction reporting mechanisms, as a result of the effect of implied duties of confidentiality in some Member States. While transaction reporting is the subject of a separate consultation[3], it is in our view an important issue. We believe it would be helpful for regulators to work together to ensure that such local confidentiality requirements do not prevent the transaction reporting central to electronic confirmation and process standardisation.

On a related, but nevertheless important point, we believe the market for clearing of OTC derivatives is and will become increasingly competitive. For example in the CDS space, there are offerings from CME, ICE, EUREX, LCH and potentially more CCPs on the horizon. Many of these entities are commercially driven for-profit enterprises. The concept of clearing concentrates rather than eliminates systemic risk by centralising counterparty risk into a central location. It is imperative that risk in the system is not increased through CCP risk management practices that do not ensure sufficient financial safeguards to manage safely counterparty defaults. To this end, the market would benefit from standardisation of a minimum set of robust legal, regulatory, financial and operational requirements. Each CCP could create customised solutions as long as these meet these minimum requirements. We do not believe that clearing houses should compete on the basis of their processes or the soundness of the legal framework. We support the establishment of standardised processes and legal infrastructure (such as strict default management standards) across clearing houses.

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 regulators should focus on two central elements of standardisation; namely legal and process standardisation, rather than on product or asset class standardisation.

As discussed above, we also believe that the best way to promote product standardisation is to permit the market to gravitate towards the product elements that

[2] "New York Fed Welcomes Further Industry Commitments on Over-the-Counter Derivatives": http://www.newyorkfed.org/newsevents/news/markets/2010/ma100301.html

[3] CESR Consultation Paper: Transaction Reporting on OTC Derivatives and Extension of the Scope of Transaction Reporting Obligations: http://www.cesr.eu/data/document/10_809.pdf

address a requirement that is shared by a sufficiently large portion of the market. Systemic risk and direct end user cost are less, in our view, as investor choice through tailoring is preserved.

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 support greater use of electronic confirmation systems for non-complex products, and advocate full compliance by market participants, to capture the majority of the market. We propose that CESR consider an approach wherein any user over a specified threshold, is obliged to use electronic confirms.

Such a threshold approach could take the form which was adopted for non-complex CDS in 2007, where initially any user over a specific threshold was obliged to use electronic confirmations, or the approach taken in the non-complex Rates market, where dealers provide details of any user who conducts more than twenty trades per month to the relevant regulator, enabling the regulator to follow up and encourage the user to make the appropriate transition. In considering this further, it is however important that sufficient regard is paid to the nature of the users of the particular asset class, which varies widely. This threshold approach should also avoid unnecessary burdens for smaller end-users, for whom infrastructure costs associated with electronic confirmations may be prohibitive. For example, the FX and Rates markets both exhibit this "long tail" (wherein a large number of users conduct transactions infrequently, typically for hedging purposes).

However, we do not believe that it is feasible to impose such a regime on certain customised products, which may not easily feed into such systems due to their bespoke characteristics. Hence we propose that consideration be given to commencing broad implementation of electronic confirmations with non-complex products where they are currently not in use and to "off-benchmark transactions" that are standardised and can support process standardisation. In addition, we believe that the industry should then work towards electronic confirmations for those subsets of complex products which can be easily described in a template format (e.g. mid-curves; options on forward starting interest rate swaps) while retaining important flexibility to use other methods of confirmation for more customised trades.

In this context, we note that the industry continues to make significant progress on initiatives to increase the use of electronic confirmations and expand the range of products covered:

In the case of CDS, DTCC provides an electronic confirmations structure, which covers Single Name CDS, Credit Index Swaps and Credit Index Tranches.

- Credit Bespoke Tranches are now confirmed via a market-wide ISDA standard template with only 17 fields to be specified and J.P. Morgan is sponsoring work in DTCC to make Credit Bespoke Tranches electronically confirmable by end of 2011.

- Global Commodities uses the ICE eConfirm electronic trade confirmation service for a significant percentage of its confirmations. The rest of the commodities market also uses this service to a significant degree.

- Equities also use DTCC as an electronic confirmations platform. As an industry, we are working vigilantly on the 2010 ISDA definitions that will lead to an increase in the number of industry accepted MCAs and electronic confirmations. In addition, we believe many firms are requiring new clients adopt industry accepted MCAs, to enable electronic confirmation from the outset.

However, should CESR elect to impose mandatory requirements in the area of electronic confirms, we seek CESR's understanding that establishing electronic confirmation facilities is time-intensive. We would therefore seek CESR's usual cooperation to ensure an appropriate transition period for market participants.

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Introductory Comments to Exchange Trading

We agree with CESR that exchange trading has a number of highly desirable properties, of which we believe the perceived core benefits for regulators to be the following:

- high level of pre and post-trade transparency;
- high standards of risk management and operational efficiency due to an association with CCP clearing (we emphasise below that CCP clearing is in fact completely independent of the execution method); and
- reporting obligations creating substantial transparency to regulators.

We concur with CESR's identification of the beneficial qualities of organised trading but would point out that these benefits *only* materialise in relation to products where exchange trading is the optimal execution method, and that have passed the relevant exchange's commercial selection process. Moreover many of the listed benefits, most significantly CCP clearing, are equally applicable and available to the OTC derivative markets.

More specifically,

- The benefits of exchange trading in terms of liquidity, efficiency and risk reduction are only likely to materialise in relation to markets for which exchange trading is the most effective mode of execution, which are likely to be markets that have naturally gravitated towards exchanges (exchange traded products trade on exchanges *because* they are liquid, not vice versa: illiquid products remain illiquid even if an exchange lists them). It is important to note that a significant selection bias applies to products that we see successfully trading on exchanges: we believe a material number of products have been introduced to exchanges and de-listed due to commercial reasons.

- It follows that while requiring certain products to trade on exchanges may achieve a desired regulatory outcome of transparency, this may in some cases be accompanied by negative implications to the market in terms of reduced trading opportunities and ability to meet demand for customer solutions. We believe that due to the characteristics of the OTC derivative markets in comparison to exchange traded markets (as we describe below) this would necessarily be the case if such forms of organised trading would be required for these markets.

- We believe it is important to keep in mind the distinction between clearing and exchange trading. Clearing is a means to manage counterparty risk, while organised trading, exchange trading and OTC trading relate to the execution method, i.e. the way the transaction price is determined rather than how risk is managed.

- We would also propose a careful and detailed review on a product-by-product basis. In the FX markets for example, the global nature and unique currency ownership of central banks, may introduce systemic risk with resulting unintended consequences on the global payments system and regional economies, should an exchange or CCP become insolvent.

In summary, we believe that the market participants and regulators can create a framework whereby the desired regulatory outcomes of transparency, risk management and operational efficiency are achieved while retaining appropriate flexibility in the mode of execution, which we discuss further below.

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 support CESR's focus on the analysis of organised trading venues and we note that CESR, in preparing the Consultation Paper, has considered the various types of organised trading venues defined by MiFID[4].

It is also important to note that exchange trading is one type of organised trading, but not the only type.

Exchange trading presents attributes such as a central limit order book (CLOB), limited exceptions or private negotiation of contracts, execution based on time and price priority, and anonymity of trading counterparty. OTC trading covers a range of execution models from bilateral negotiation of contracts to various multilateral execution models (some of which are highly organised and electronified). Thus we see a continuum between bilateral clearing, through multilateral trading, to omni lateral ("all-to-all") exchange trading.

The existence of such flexible "execution continuum" dependent on market characteristics is demonstrated by the variety of currently existing models which we believe are based on the optimality of the execution model for each market.

- Treasury futures trade on exchange, but Treasuries themselves continue to trade bilaterally, although some increasingly trade on other forms of organised trading platforms.

- Preferred stock, half way between corporate bonds and OTC, trades both on exchanges and OTC.

- Short-dated Libor-based derivatives trade almost entirely on exchange, long-dated ones trade primarily OTC.

- More liquid commodities are almost entirely exchange traded, less liquid ones, and longer dated contracts, have a higher percentage of trading in venues outside of a central limit order book model.

- Many highly standardised instruments, such as bonds, do not typically trade on exchanges (even though they may be listed on exchanges) but the majority are executed OTC.

[4] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, the Committee of the Regions and the European Central Bank. Ensuring efficient, safe and sound derivatives markets, (Ref. COM (2009) 563 final), page 8

We believe it is important for a healthy financial system to have enough flexibility to optimise liquidity by settling on the optimal mode of execution for every product in this way.

Like CESR, we believe that a certain level of standardisation is a pre-condition for exchange trading; however the more important and necessary conditions are (a) continuous liquidity, (b) the existence of a large number of participants with matching trading interests, enabling those interests to be matched without need for an intermediary; and (c) concentration of liquidity on a relatively narrow number of highly traded instruments, as will be demonstrated in the answers below.

Requiring a specific market that does not share these characteristics to select a mode of execution at the exchange end of the continuum, will in our view lead to a sub-optimal outcome in terms of reduced liquidity or outright absence of certain financial products from the markets going forward. As we note in our introductory remarks, it follows that the benefits of exchange trading in terms of liquidity, efficiency and risk reduction are only likely to materialise for markets which share the above characteristics and for which exchange trading is the most effective mode of execution; and that the answer to how the stated benefits can be achieved with respect to a particular asset class will be found by determining which type of organised trading is best suited for that particular product.

Further to the above, it is important to consider some of the limitations of exchange trading relating to competitiveness and creation of monopolies, and the effect of exchange trading on the range of products available to consumers of financial products.

Typically, exchanges are for-profit commercial entities, which need economies of scale to be feasible. The cost of developing a platform is higher for products where a limited range of instruments is suitable, and the requirement for profitability has led many "standardised" products introduced to be de-listed due to lack of demand or lack of sufficient trading due to the product not meeting the users' needs.

For the same reason, exchanges tend to have a monopoly on specific products. In equity indices, for example, exchanges own the intellectual property rights and as a result any index is only listed on a single exchange. In any product, liquidity is typically found on a single exchange despite similar products being listed on other exchanges. For example, according to the July traded volumes of Euribor futures, 99.9% of volume is traded on Liffe and 0.1% on Eurex[5] 100% of Eurodollar futures volume is traded on the CME with 0% trading on SGX, despite being listed on both[6]. This contrasts to the very competitive OTC markets, where dealers are placed in competition on products which trade on standardised terms across the market regardless of platform. Imposing a requirement on markets to operate on a specific type of a trading platform could therefore have the impact of removing competition, and we encourage a model that allows and offers visibility on the different types and availability of trading venues.

[5] Source: www.euronext.com and www.eurexchange.com

[6] Source: www.cmegroup.com and www.sgx.com

Finally, it is important to note that in addition to the potential increased cost in terms of liquidity, exchange trading does not have an unambiguous impact on transaction costs. If exchange trading is forced, we believe one of the results is likely to be increased price variability and therefore higher transaction costs.

In addition we would like to specifically comment on the following paragraphs in the consultation document:

- With reference to paragraphs 66 and 67, it is important to acknowledge that a high level of pre and post-trade transparency exists on the OTC market[7]. Specifically, a high level of regulatory transparency is available through trade repositories such as DTCC, to both regulators and, where applicable, market participants. We also believe that OTC market has an effective price formation process (paragraph 67).

- Electronic confirmation is not dependent on exchange trading (in reference to paragraph 69). CCP clearing can equally be done for OTC executed transactions (paragraph 70) and is evidenced through the progress that has been made for example, in implementing CCP clearing for Interest Rate Swaps ("IRS") and CDS.

- With reference to paragraph 68, we have noted above that we do not believe that trading on organised platforms enhances liquidity unless the product is naturally suited to the specific trading environment. We have also noted that the OTC market is very competitive and clients are able to put dealers in competition on existing platforms.

- With reference to paragraph 76, we note that this specifically refers to the "off-benchmark" standardisation of IRS and CDS contract, and further note that even though these contracts are not suitable for exchange trading, they can be traded on Request for Quote (RFQ) based platforms such as TradeWeb, Bloomberg or MarketAxess and they can be CCP cleared, despite their bespoke terms.

- With reference to paragraphs 73 and 78, we believe that the liquidity consequences of sub-optimal execution models and levels of transparency have very real impacts to <u>all</u> market participants with repercussions to the real economy without positively impacting the objectives of transparency, risk management and operational efficiency, which we will discuss further below.

- With reference to paragraph 79, we would like to clarify the causality implied in the statement that "the typical unit size is currently higher in OTC markets, due to the professional participation in these markets and the bespoke nature of contracts". We note that it is specifically the characteristics of the OTC markets, of which professional participation and existence of bespoke contracts are some of the attributes, which lead to traded sizes being smaller

[7] AFME, BBA and ISDA Joint Response to Committee of European Securities Regulators (CESR) Technical Advice to the European Commission in the Context of the MiFID Review: Non-equity markets transparency http://www.bba.org.uk/bba/jsp/polopoly.jsp?d=155&a=17856

on exchange traded contracts and larger on privately negotiated contracts. This will be further explored below.

On a related matter, we draw CESR's attention to the following issue, as referenced earlier: local requirements sometimes preclude consistent EU reporting by CCPs and dealers to regulators as a result of the effect of implied duties of confidentiality in some Member States. While transaction reporting is the subject of a separate consultation[8], reporting is in our view an important issue. We believe it would be helpful for regulators to work together to ensure that local confidentiality requirements do not prevent the required reporting by CCPs and dealers.

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

As indicated above, the nature of liquidity and participation on each market determine which execution method is the most effective, and forcing a specific market to a particular mode of execution that it has not selected naturally will lead to a sub-optimal outcome. We believe that the answer to this question will depend on which are the products or markets where most of the liquidity is on exchange, and which are the products or markets where most of the liquidity is bilateral or privately negotiated. It will be relevant to explore whether certain markets or products would be better served by an organised trading venue that falls between OTC and exchange trading.

Markets with a natural tendency towards the OTC range of the execution continuum (i.e. that find OTC execution the most effective execution method) typically share the following characteristics:

- Professional participants and very low or absence of retail participation. The number of interested parties is small and significantly smaller than number of parties on an exchange.

Liquidity is spread over a large number of instruments idiosyncratic in terms of risk and ratio of instruments to participants is high. Our preliminary analysis shows that due to the small number of participants and high number of instruments, the ratio of instruments to participants in the OTC markets is such that there can be less than one participant per instrument. Even in Treasuries or corporate bonds, where the participants are many, the number of instruments is big enough that there is still more liquidity in bilateral execution. Table 1 on the following page demonstrates this in reference to CDS, IRS and some of the main European or North American futures markets.

[8] CESR Consultation Paper: Transaction Reporting on OTC Derivatives and Extension of the Scope of Transaction Reporting Obligations: http://www.cesr.eu/data/document/10_809.pdf

Table 1: Estimation on participant and traded instrument numbers in selected OTC derivative and exchange traded markets

	Number of active participants[1]	Approximate # of benchmark instruments	Number of total instruments	Participant to "benchmark" instrument ratio	Participant to total instrument ratio	Average number of benchmark trades per day	Average number of total trades per day	Methodology and Assumptions - number of participants		
								Number of participants	Number of instruments	Number of trades/ day
Single Name CDS (Europe)	200	175	88,320	1.14	0.002	1.9	4.3	Used internal JPMC client trading data to estimate number of active participants in Europe (defined as trading at least ~5 times per year). Assumes JPMC trades with all active participants	Included all 125 names in Itraxx Main and 50 in Crossover indices for "benchmark instruments" For total European traded entities assumed 368 entities (JPM internal data), with 40 maturities and 6 coupons each	Used data for top 1000 SN CDS globally from DTCC report "Market Activity Snapshot". Assumed 45% of trades happen at 5Y point (benchmark) per previous JPMC analysis
Index CDS (Europe)	180	4	160	45	1.125	~200	~250	Used internal JPMC client trading data to estimate number of active participants in Europe (defined as trading at least ~5 times per year). Assumes JPMC trades with all active participants	Assumes benchmark products are "on the run" and previous index series for both Itraxx Main and Crossover Assumes 10 active series and average of 4 maturities per series for total producs for each index	Estimate total number of trades per day in Europe at 250/ day based on interviews Assumed 70% of trades happen at 5Y point (benchmark) as per previous JPMC analysis
Vanilla IR Swaps (Europe)	390	>25	>100,000	<15.6	<0.004	~700	~1000	Used internal JPMC client trading data to estimate number of active participants in Europe (defined as trading at least ~5 times per year). Assumes JPMC trades with all active participants	Assumes 10+ short term benchmarks (<1Y), another 10 (1Y – 10Y) and at least 5 in over 10Y maturities. For total instruments number shown is a lower bound since in reality each trade is a unique instrument	Used preliminary MarkitSERV May data, applied a correction factor of 0.85 to account for post-trade allocations Assumes 75% of trades reported through MarkitSERV
Brent Crude Oil Futures (Europe)	>20,000	1	78	>20,000	256	195,000	>390,000	High level estimates based on JPMC internal interviews with Oil Trading team	A maximum of 72 consecutive months will be listed. In addition, 6 contract months comprising of Jun and Dec contracts will be listed for an additional three calendar years. Front-month is "benchmark" contract	Daily volume based on ADV 2010 data Assumes 50% of trades are in the front month "benchmark" contract
S&P e-minis (US)	>150,000	1	5	>150,000	>30,000	>160,000	>200,000	Assumes that 1/3 of E*Trade's ~3mm accounts are active participants in S&P e-Minis trading Actual number of total active participants likely to be higher	For total instruments, counted all 5 outstanding quarterly contracts (Sep '10 – Sep'11) as per CME product specification information	July 2010 ADV is 2.1mm contracts, assumes average trade is of ~10 contracts (could be lower) Assumes 80% of trades are in short-dated "benchmark" contract
EURO STOXX 50 Futures (Europe)	>20,000	1	3	>20,000	6,667	>120,000	>150,000	High level estimates based on JPMC internal interviews. Actual number of total active participants likely to be higher.	For total instruments, counted 3 outstanding quarterly contracts (Sep '10-Mar'11) as per Eurex product specification information (contract months are the three nearest quarterly months of the Mar, June, Sept, Dec cycle)	July 2010 ADV is 1.5mm contracts, assumes average trade is of ~10 contracts (could be lower) Assumes 80% of trades are in short-dated "benchmark" contract

Source: DTCC data, E*Trade public information, preliminary Markit data, Internal JPMC data and interviews

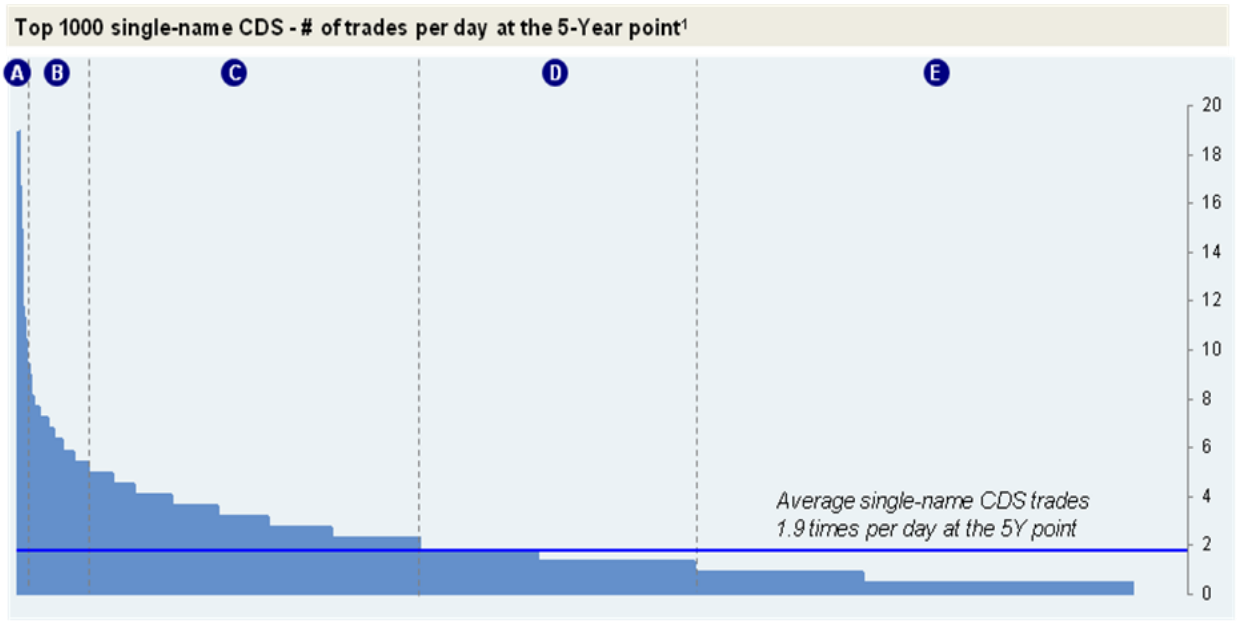
[1] Defined as trading at least 5 times per year

[2] Note that for S&P e-mini numbers reflect estimates on number of orders rather than number of trades (as orders get broken down by algo systems into multiple trades)

- On average, the number of transactions in the OTC derivative markets in a single instrument is low. Graph 1 shows data from the recently published DTCC data on the top 1,000 most liquid Single Name CDS, adjusted with additional assumptions based on J.P. Morgan trading data, which demonstrates that out of the 1,000 reference entities:
    - The average Single Name CDS trades 1.9 times a day at the 5Y maturity point;
    - Only 7 names trade more than 10 times a day;
    - Only 341 names trade 2 or more times a day; and
    - *4*25 names trade less than 1 times a day

  This shows that even in the most liquid maturity point, the average trading frequency is low.

Graph 1: Number of trades per day for the top 1000 global Single Name CDS



Source: DTCC data adjusted per JPMC internal analysis. DTCC Data is available at http://www.dtcc.com/products/derivserv/data/index.php..

A 7 names trade more than 10 times per day
B 52 names trade more than 5 times per day, but less than 10
C 282 names trade more than 2 times per day, but less than 5
D 234 names trade more than 1 time per day, but less than 2
E 425 names trade less than 1 time per day

[1] Assumes that 45% of volume is concentrated on the 5 year point (as per previous JPMC analysis)

- The participation, liquidity, trading frequency and traded ticket size characteristics in the OTC derivative markets (further discussed in our response to Q11) demonstrate that transactions are typically done with the objective of transferring risk from those participants unable or unwilling to hold the risk, to those who are able to manage it.

- It follows from the above characteristics that there is typically a timing gap between the emergence of a natural buyer and seller for a particular instrument. OTC market makers bridge the timing gap and enable execution by taking risk onto their balance sheet.

We discourage the notion of "moving" or forcing certain segments of the market towards exchange trading; the overall level of organisation of the market cannot be increased through regulatory action. We believe that the key policy objectives of systemic risk reduction, transparency, customer protection, anti-manipulation enforcement and increased liquidity can be supported through a number of organised trading mechanisms outside exchange trading that provide equal benefits while ensuring continued effective functioning of the market. Importantly, CCP clearing is a key mechanism in the reduction of systemic risk and provided that a transaction is economically affirmed prior to submission to the CCP, clearing is agnostic to the method of execution. We also note that markets are dynamic in this respect, and many asset classes such as CDS are naturally gravitating towards an increased degree of multilateral trading in a more organised fashion. From a regulatory perspective we believe that the approach most likely to yield the stated policy objectives would rather propose the identification of methods (such as anti-manipulation measures, and post-trade transparency) that will enable the maximum regulatory transparency and mitigation of systemic risk, while maintaining the flexibility for the market to select the optimal mode of execution for each product.

Another important point to note is that without full recognition of the distinct properties of the OTC market structure, the natural tendency of rules mandating exchange trading or real time post-trade transparency to the market will be to decrease ticket size and increase trade frequency. While these developments could be perceived as desirable, there are two important caveats.

- First, an increased frequency of transactions coupled with decreasing size is not a sign of increased liquidity but likely to be demonstrative of an underlying issue with regards to the ability and willingness of market participants to perform effective risk transfer transactions – and hence can be a sign of an inefficient rather than an efficient market. Consequently, the system makes it hard to facilitate a significant amount of risk transfer or hedging without execution risk to the end user.

- Second, such a trading structure (highly electronified, with a high number of transactions with small sizes) does not necessarily help to manage systemic risk. We believe it is possible that such a structure may well have contributed to the recent "flash crash" in the US by making the system more vulnerable to a systemic trigger in comparison to a system where some moderating human interaction takes place. The human element that is characteristic of most OTC markets, when compared with the computerised automatic acceptance of a price,

acts as an additional check point and brings a degree of protection to the client. While the rules have lowered transaction costs for retail investors, it is unclear whether any cost benefit would be achieved in OTC derivatives taking into account the lack of retail participants, and a certain increased cost to the market in terms of diminished liquidity or outright lack of specific trading opportunities.

- Finally, it is important to note both the existing high degree of organisation in many execution models in the OTC markets, and the natural evolution that is occurring on these markets towards an increased level of organisation where appropriate. A high degree of bilateral or multilateral organisation is already in place in the dealer to dealer market through brokers (equally though voice and through electronic trading), and on the dealer to client market through different forms of electronic trading through platforms such as Bloomberg. We also note that markets undergo a natural evolution with respect to the continuum between OTC trading, through multilateral trading, to exchange trading. A number of market segments, which were traditionally set on an OTC execution method, are gravitating naturally towards an increased degree of organised trading. By way of example, in the case of index CDS (Itraxx, CDX) trading is already highly organised and trending towards increased electronification, and RFQ (Request for Quote) offerings already exist. We expect and support further innovation in this area.

Q10: In your view, for which sectors of the market will increased transparency associated with exchange trading increase liquidity and for which sectors will it decrease liquidity? Please specify.

It is our view that any transparency model that discourages the market in that it fails to meet the demand and risk mitigation requirements of market participants will impact liquidity. Therefore, whatever the execution model, the transparency criteria (pre-trade and post-trade) must be calibrated for the specific market to ensure continued efficient functioning of that market.

With regards to pre-trade transparency, we would make the following points:

- A high level of pre-trade information already exists on the market[9]. In particular, dealers competing for client business are creating a high level of transparency for buy-side participants. Clients in the OTC derivative markets are professional investors, who, we believe, at any point in time have a very clear view of market prices based on a system of bilateral quotations through voice and electronic platforms.

- Even in exchange traded markets, we observe a high proportion of privately negotiated transactions. Exchange trading models in both Europe and the US display flexibility in the allowance of bilateral negotiation that is tailored to the needs of the specific market. This ranges from the more limited allowance for private negotiation in the mature US equities market to over 20% of contracts in US energy futures and over 60% in US energy options that are

[9] AFME, BBA and ISDA Joint Response to Committee of European Securities Regulators (CESR) Technical Advice to the European Commission in the Context of the MiFID Review: Non-equity markets transparency http://www.bba.org.uk/bba/jsp/polopoly.jsp?d=155&a=17856

privately negotiated[10]. We would consequently reinforce the importance of any pre-trade transparency model being appropriately calibrated to the relevant market to facilitate continued liquidity in the specific market, even if the product characteristics were such that it was suitable for exchange trading in some form.

- It should not be assumed that wide publication of trading interests pre-execution is the most effective method of price discovery at all times. It follows from the OTC derivative markets characteristics listed in Q9, that pre-trade publishing requirements could lead to increased bid offers for contracts that are less liquid, making the price discovery process less efficient overall. In contrast, the end user would be likely to get more competitive pricing by placing multiple dealers in competition by requesting quotes via an RFQ (Request for Quote) mechanism, with the resulting transaction being reported post-execution with appropriate size and liquidity based delays.

With regards to post-trade transparency, we would make the following points:

We believe that full post-trade transparency to regulators is central to enabling effective systemic risk monitoring and market surveillance to be undertaken by regulators, and we strongly support maximum transparency to regulators in this respect. In order to ensure that a post-trade transparency regime is an effective tool for regulators to use, it is imperative that workable, consistent rules are agreed that govern data quality and submissions. However, as is set out in the combined industry response to the CESR Non-Equity Transparency consultation[11], we are of the view that any new measures relating to public transparency must be carefully considered, with potential benefits weighed against the likely negative impact such measures will have on market liquidity and ultimately on costs to institutions who use these instruments to manage risk. Post-trade transparency without adequate size and liquidity calibration will force market participants to break up their flow into small sizes and decrease the available capital market makers will be able to put at risk, resulting in a negative impact of liquidity, restriction of flow to most liquid instruments, and a shrunk market size. We believe that this would be a negative outcome for the market as a whole. Given particularly the professional nature of OTC derivative markets, the benefits of public transparency may be outweighed by the potential very real cost to the market from reduced ability of market makers to facilitate risk transfer transactions of size, consequent reduced liquidity, and increased cost to the end user including both professional institutions and public entities such as government agencies. A key success factor of a post-trade reporting regime will be the proper design of the transaction reporting template and specification of the data required. This includes consistent agreement on, and application of parameters to indicate in-scope trading volume. We believe that this is achievable within a reasonable timeframe through close engagement between the regulatory

[10] Source: www.cmegroup.com

[11] AFME, BBA and ISDA Joint Response to Committee of European Securities Regulators (CESR) Technical Advice to the European Commission in the Context of the MiFID Review: Non-equity markets transparency.

http://www.bba.org.uk/bba/jsp/polopoly.jsp?d=155&a=17856

community, industry, and the existing transaction reporting specialists. Alongside the industry, we are keen to work with the regulators to contribute to the solution. We firmly believe that a successful implementation of this step will supply all parties with much higher quality data which will facilitate further rule making to be fact driven and appropriately responsive to market conditions. While we support the rationalisation of infrastructures for post-trade reporting and where possible utilising the trade repository infrastructures, the post-trade transparency regime must acknowledge the challenges that would be involved in distilling relevant execution data from the existing repository submissions. Options should therefore be considered for creating a separate post-trade reporting template for this purpose.

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

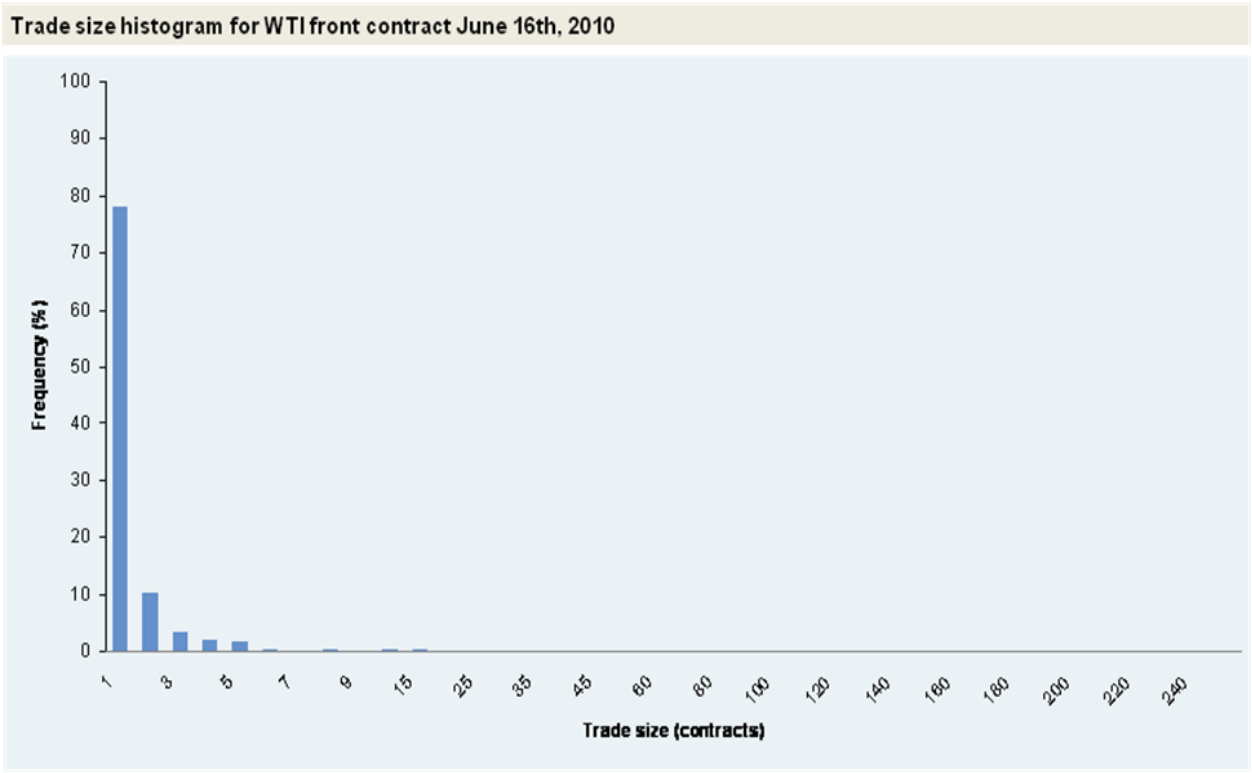
We have previously noted the range of execution modes along the continuum, from an "all-to-all" central limit order book (CLOB) model to bilateral execution, with different multilateral models in between. In an exchange execution paradigm, participants must trade on an exchange ("all-to-all" CLOB) unless a trade qualifies as a block trade and bilateral (privately negotiated) execution is possible. In an OTC execution paradigm, participants can choose the optimal execution model along the continuum, which can range from an "all-to-all" model to a bilateral model. In between, orders can be shown to and negotiated with multiple participants, but not necessarily "all-to-all."

It is important to note the specific characteristics of different execution modes along the continuum with respect to typical trading sizes, and treatment of "block" trades in large sizes, and the allowance of private negotiation. This will show that there are further specific characteristics of the current OTC derivative markets that follow from those discussed under Q9 and necessitate a flexible execution model where participants can choose the optimal mode of execution. Specifically, OTC derivatives contracts typically trade in sizes that are similar to the privately negotiated "block" trades in an exchange environment. There is no equivalent in the OTC market to the retail size activity that forms the vast bulk of exchange trading activity. The institutional large OTC trades or "OTC blocks" that form much of the risk transfer activity on the OTC market, have no equivalent in an exchange context.

Graphs 2-4 below demonstrate the trading size differential between exchange traded and OTC markets.

Graph 2: Using data for the ICE West Texas Intermediate (WTI) Futures Contract, we find that in the daily data sample used more than 90% of the trades were small in size, characterised as two or less contracts[12]

Graph 2: Trade size distribution for an example futures contract



Source: Nymex data

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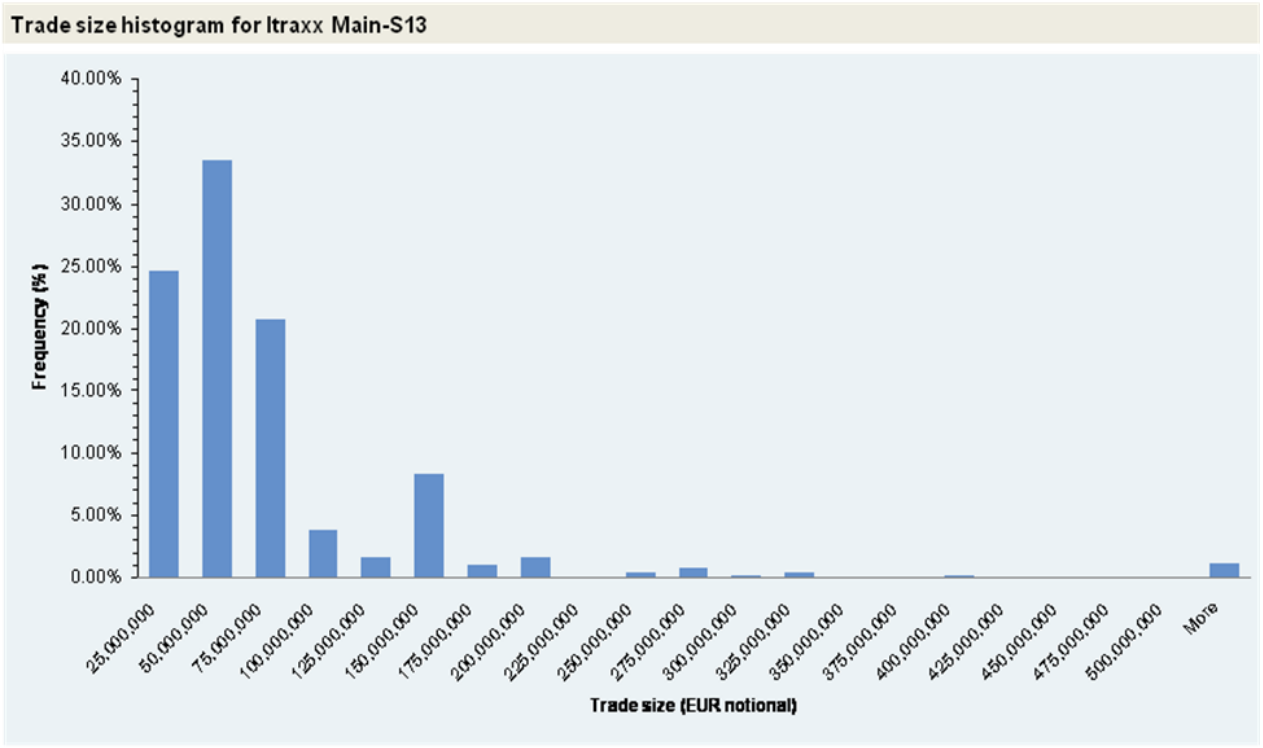
[12] Source: www.theice.com

Graph 3: Using internal J.P. Morgan data, for European on-the-run CDS Index transactions in 2010, we show that the percentage of large trades is significantly higher.

Graph 3: Trade size distribution for an example OTD derivatives contract



Source: JPMC internal data

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Graph 4: Using data on selected OTC derivatives and futures contracts and normalising for volatility, we show that the typical trade sizes in OTC markets are comparable to block trade minimum sizes for futures.

Graph 4: Futures and OTC derivatives contract size - normalised for volatility

Current futures market (liquid contracts) - *examples*

	Block Trade minimum (# contracts)	**Block Trade minimum size** ($mm)	**Daily volatility** (2 Standard Deviations)[1]	**$ - equivalent 2 standard deviation range**
10 year note (futures)	5,000	615	0.78%	4,810,000
30 Day Fed Funds (futures)	2,000	9,980[2]	3.10%	50,000
HH Natural Gas (futures)	100	5	5.31%	260,000
Gold (futures)	200	25	2.06%	490,000
EUR/USD FX (futures)	150	25	1.50%	370,000

Current OTC Derivative market (typical trades) - *examples*

	Typical trade size[3] ($mm)	**Daily volatility** (2 Standard Deviations)[1]	**$ - equivalent 2 standard deviation range**
NA HG Index	125	0.29%	390,000
NA HY Index	25	1.25%	320,000
5Y IRS	100	0.59%	590,000
1Y EUR Straddles	100	0.19%	190,000
Spot EUR/USD	25	1.50%	370,000
1Y 10Y Swaption Straddles	100	0.07%	70,000
1Y S&P Variance	300,000 (vega)		230,000

Source: Bloomberg, CME Group, JPMC analysis
Note: all calculations are based on observed data for 08/02/2010 and numbers are rounded to nearest $10,000
[1] 2 standard deviations used to calculate risk with a 95% confidence level
[2] Each contract is based on $5mm of notional. Please note the volatility number shown is that of the interest rate as value at risk is a function of the volatility on the rate rather than on the notional
[3] Typical trade size refers to the most common trade size in the professional dealer community

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More specifically, we note the following:

- Generally, we believe that the more idiosyncratic and customised the product and less retail flow a product has, the higher the percentage of privately negotiated or block trade volume. For example, looking at US Crude Oil Futures that trade on CME, we can see that block trading as a percentage of total volume increases with the maturity of the contract: using samples of dates in July and August 2010, we can see that block trading as a percentage of total volume was 2.2% for contracts maturing in September 2010, 10% for contracts maturing in December 2011, and 20.3% for contracts maturing in December 2013. We can similarly see that in comparison to Crude Oil Futures, block trading increases as we move to less liquid or smaller markets such as Gasoline RBOB Futures where daily traded volume was approximately seven times less for the samples observed: block trading volume for Crude Oil Futures was 2.96% compared to 4.30% for Gasoline RBOB futures (note that both of these are considered CME core energy products and are therefore highly liquid – looking at variations of these products such as Crude Oil Calendar Swaps the percentage of block trading increases significantly). Observing block trading percentages for Metals and Energy, the percentage of block trades is higher for Options relative to Futures[13].

- In the current market, if the natural state of execution is to have a material percentage of flow be privately negotiated, the OTC market provides an escape valve to provide execution flexibility. Within exchanges, we do not observe many contracts with high percentage of privately negotiated volume because those products will tend to gravitate towards OTC trading.

- We believe that there is significant scope to fill this "continuum gap" with OTC forms of organised trading, yet still allowing for a liquidity outlet when private negotiations are optimal.

The OTC market is therefore not only focused on the ability to customise. It also provides an "outlet" for risk transfer on assets that are less liquid. If the outlet was shut off by restricting the ability of professional participants to move institutional amounts of risk in the optimal form, the overall liquidity and market efficiency will be reduced and systemic risk potentially increased through some market participants holding undesired risk. It should be ensured that the incentives for professional intermediaries to commit risk capital and provide liquidity to their customers be preserved.

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

Referring to our response to Q9 above, in high level generic terms we can look at the number and nature of participants in the particular market, the number and idiosyncrasy of instruments, the ratio of participants to instruments, and the average frequency of trading in the instruments. We believe that the markets where these characteristics combine in such a way as to make the market suitable for an exchange

[13] Source:www.cmegroup.com

execution model, will naturally gravitate towards exchange trading. In the competitive market environment, exchanges or trading platforms are likely to identify such products as opportunities and develop a product offering if sufficient demand is deemed to exist.

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?

Referring to our responses to Q8 and Q9 above, we agree that a certain level of standardisation is a pre-condition for exchange trading, however the more important and necessary conditions are continuous liquidity, the existence of a large number of participants with matching trading interests, enabling those interests to be matched without need for an intermediary; and concentration of liquidity on a relatively narrow number of highly traded instruments. It is important to point out in this context that while "off-benchmark" standardised contracts or other relatively non-standard contracts may not be suitable for exchange trading, they are often suitable for trading on other types of electronic platforms, for CCP clearing, and electronic confirmation and can therefore fulfill the objectives of transparency, risk management and operational efficiency.

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.

We do not believe that CCP clearing is a pre-requisite for the use of organised trading platforms including exchanges; models exist whereby dealers bilaterally clear transactions entered into through an organised trading platform.

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

Organised trading as such does not necessarily require full fungibility, although non-fungible contracts will form separate pools of liquidity for the purposes of trading. We note however that contracts must be fully equivalent in economic and legal terms in order to be netted for the purposes of CCP clearing and collateral.

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

Please refer to our answers to Qs 8-11. We specifically note that there is already a high degree of organisation in many execution models in the OTC markets, and where appropriate a natural evolution is occurring on these markets towards an increased level of organisation.

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.

Please refer to our response to Qs 8-11. We further note that we do not believe that the current state of the market is demonstrative of a market failure. As noted above,

markets will naturally gravitate to the most effective mode of execution and a natural evolution towards electronification is occurring where appropriate. If a product is traded on organised platforms in a limited fashion, this is likely to be demonstrative of the specific platform only meeting the market needs in a limited way. This corresponds to the evidence of swap contracts that have been introduced by different exchanges over the recent years and have not been successful. Moreover, existing trading venues are used by participants according to their preferences and usage is likely to flow towards those that are most suited to their needs. We do not believe that a regulatory intervention to force a product to trade more extensively in a specific venue would lead to increased market efficiencies or stability.

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 agree that there are some areas of market structure (such as in ensuring consistency in jurisdictional legal structures and market infrastructure standards) in which the market left unchecked may not always yield the right solutions and regulatory action is more appropriate. We note that in relation to OTC derivatives, such action has been agreed between the industry and regulators on a voluntary basis through a high level of engagement and organisation between regulators and industry groups, and made public through the OTC Regulatory Forum Letter[14] referenced earlier in this response.

There are other areas where the combination of competitive forces and focus on providing the right customer solutions will be the key driving forces for progress and we are of the view that regulatory action in these areas is likely to result in unintended consequences which negatively impact the very issues the authorities are seeking to address. Pre-trade transparency is one of those areas, and we firmly believe that regulation of the pre-trade process by means of not allowing flexibility on the extent to which trading interests are publicised prior to the execution will not result in additional transparency benefits in relation to post-trade reporting to the regulators, but will impose a very real cost to the market and the end users in terms of liquidity and flexibility of organisation of the execution process. We believe that even the existing regimes of organised trading designed for highly liquid products acknowledge this through specific limitations on pre-trade transparency and varying degrees of allowance for private negotiation/ block trading – even in the US where the equities market is very mature. As noted above, it should not be assumed that showing trading interests to the whole market constitutes an effective method for price discovery.

We have introduced above the concept of an execution continuum from bilateral to exchange trading where the availability of flexibility in terms of the degree of multilateralism ensures that trading counterparties can select the most optimal method of execution while maximising liquidity in the specific product. Mandating any specific degree of multilateralism, or imposing a binary trading paradigm (trading either on, or outside exchange trading) would deprive the market of the diversity and

[14] "New York Fed Welcomes Further Industry Commitments on Over-the-Counter Derivatives": http://www.newyorkfed.org/newsevents/news/markets/2010/ma100301.html

flexibility of execution modes available through different voice, or electronic trading platforms that are able to support the desirable idiosyncrasies of the OTC derivative markets.

We acknowledge that a degree of scepticism may exist towards this view due to the seemingly beneficial attributes of exchange trading in terms of transparency, which we have noted earlier. However, we firmly believe that the targeted policy objectives can be achieved while maintaining pre-trade flexibility, and we wish to work with CESR and the European Commission to further define the optimal means:

- As discussed in Q10, a well calibrated post-trade transparency regime including liquidity and size differentiation and with industry-agreed consistent templates will allow regulators to receive and analyse appropriate and reliable data on trading activity for the purposes of monitoring and anti-manipulation surveillance.

- Reporting of positions to trade repositories will provide the regulators a systemic view of exposures on OTC derivatives and we strongly support the progress towards 100% derivatives coverage.

- CCP clearing of OTC derivatives is not dependent on the execution method, demonstrated by the highly successful IRS, commodity swap and CDS CCP projects that have already been implemented for dealer to dealer positions. In the case of CDS, we note that ICE Trust (US) launched US CDS Index clearing in March 2009 and Single Name CDS clearing in December 2009, and as at the end of July has cleared $6.3 trillion in CDS notional value (including $300bn in Single Name CDS) resulting in open interest of $435bn[15]. ICE Clear (Europe) went live with European CDS Index clearing in July 2009 and Single Name CDS clearing in December 2009, and as at the end of July has cleared $3.8 trillion in CDS notional value (including $500bn in Single Name CDS), resulting in open interest of $464bn. Progress continues towards implementing further clearing for dealer to client positions during 2010. In the case of IRS, the volume cleared by SwapClear at the end of June 2010 stood at $225 trillion[16]. Significant commodity swap volumes are cleared through CME ClearPort and ICE.

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.

The current OTC derivatives trading models/ platforms have the ability to make pricing information available on a bilateral, or varying degrees of multilateral basis. As discussed above, the key to the current OTC pre-trade and execution model is the wide availability of pre-trade information to the market participants, while having flexibility with regards to the extent that trading interests are made public prior to execution. We have noted that it is not always desirable from a price discovery

[15] ICE clearing statistics: available at www.theice.com.

[16] http://www.lchclearnet.com/media_centre/press_releases/2010-07-19.asp

perspective to show prices on a fully multilateral basis, and consequently a "continuum" of execution models is required from bilateral to degrees of multilateral execution, and the demand has resulted in multiple providers developing such service offerings.

A number of platforms are able to make pricing information available on a multilateral basis[17]. In products such as Interest Rate Swaps, multilateral live pricing is provided to the market real-time on a firm commitment basis, with electronic execution through platforms such as Bloomberg. Further examples of services providing pricing on a multilateral basis include platforms that consolidate, organise and display dealer prices or pricing "runs" in various formats, and typically produce their own composite intraday and end-of-day prices, including Bloomberg, MarkIt, and CMA. Platforms such as Bloomberg and TradeWeb provide live pricing data and RFQ (Request for Quote) functionality that allows multiple dealers to be put in competition to allow for best execution. We also note that CCP clearing will provide an important source of end-of-day pricing going forward.

We agree that Single Dealer platforms play an important role in the progress towards electronification of OTC derivatives execution, to the extent it is possible and desirable. We believe that to the extent that any regulatory regime recognises the utility of private negotiation, it should be permitted by any means, including through Single Dealer electronic platforms, which enable an electronic form of bilateral negotiation as well as accommodating a multilateral form of price transparency. To the extent that any regulatory mandate is proposed for the price formation process, the mandate should be principles based and any platform (including Single Dealer) platform should qualify to the extent that it satisfies those principles – which we believe include the objectives of liquidity, customer protection, and monitoring/ supervision. For example, an increasing degree of CDS Indices are traded through Single Dealer electronic platforms which provide the ability to demonstrate that trades are executed within the standard bid-offers, and have the required capability for monitoring, and post-trade reporting. Again, we note that the regulatory burden on such platforms should be lower due to institutional participation.

We reiterate that it is our belief that the key regulatory policy objectives can be achieved through an appropriate post-trade transparency regime. Any of the current electronic trading platforms will have the capability of producing the required post-trade reporting. As noted previously, we believe that the key to the success of the regime is the creation of consistent templates to ensure clean available post-trade transparency data to the regulators to establish an accurate view on market liquidity and activity, and we are very keen to work with CESR and the European Commission in the development of the principles and the detailed technical standards.

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

It is not obvious how a Systematic Internaliser regime would be applicable to OTC derivatives given the primarily institutional participation. We note that as reflected in

[17] AFME, BBA and ISDA Joint Response to Committee of European Securities Regulators (CESR) Technical Advice to the European Commission in the Context of the MiFID Review: Non-equity markets transparency http://www.bba.org.uk/bba/jsp/polopoly.jsp?d=155&a=17856

the recent CESR Technical Advice to the European Commission, the regime is under review with reference to equities. However, it is important to bear in mind in this context that the frameworks of Systematic Internalisers and crossing networks may have some important policy considerations that are relevant to the consideration of OTC derivatives, specifically with regard to the flexibility required in relation to the mode of execution and ability to execute privately negotiated trades where appropriate. In the equities context, there has been much recent focus on the development of dark pool venues. We believe this has developed as a result of institutional participants searching matching trading interests without exposing their pre-trade interests to the whole market, with the objective of enabling the desired risk transfers to take place which may otherwise have ceased and left market participants with basis risk. It is important to note, hence, that even in the highly regulated and liquid equities markets, it is not always ideal for market participants to publish their trading interests, and flexibility with regards to pre-trade transparency and execution is fundamental.

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?

As noted in our response to Q 20 above, we do not consider that the current SI-regime provides the benefits described. Please see our detailed response to Q 20.

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"?

While we do not immediately see a relevance of crossing networks to OTC derivatives, we welcome CESR's effort to establish which qualities of organised trading platforms are important in the consideration of suitability in relation to OTC derivatives, and we support and we would welcome the opportunity to participate in efforts to define how trading platforms can cater for the requirement for flexibility in terms of execution modes and private negotiation.

As discussed above, we believe that the key factors in the consideration on the extent to which trading platforms are able to support OTC derivatives execution activity are the following:

- Flexibility to select the optimal degree of pre-trade transparency;
- Appropriate and sufficient allowances for bilateral/ private negotiation, taking into account the large average traded sizes for OTC derivatives (and bearing in mind that most OTC derivatives contracts would fall under this requirement);
- Appropriately calibrated regime for post-trade transparency, differentiating for size and liquidity (note that to the extent that organised platforms do not allow for flexibility in post-trade transparency, there will still be need for an OTC market); and
- Provision of regulatory reporting to allow monitoring, surveillance and customer protection.

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 note that the ultimate definition of an organised platform within the forthcoming US regulation is not yet clear, although the introduction of the concept of "Swap Execution Facility" suggests that flexibility is envisaged instead of a strict CLOB model.

We believe that as a result of MiFID, European regulators are currently advanced in agreeing a definition of a market structure that supports the development of stable and efficient markets. While regulatory arbitrage should be avoided, we believe that from the perspective of the market it should also be ensured that the MiFID construct is not allowed to be watered down from the perspective of fostering competition.

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?

Please see our response to Q 25.

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.

We have noted above the requirement for flexibility in the degree of multilateralism selected for pre-trade transparency – any trading platform for OTC derivatives should accommodate the full continuum of modes of execution and pre-trade transparency.

We have further noted the requirement for flexibility in post-trade transparency, and that the appropriate calibration of any post-trade transparency is critical particularly in the light of the importance of accurate post-trade reporting to the regulators in the achievement of the targeted policy objectives.

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

As discussed in Q 8, exchange trading should not be considered as a policy objective per se. We believe it is important that each market selects the optimal execution method, and have highlighted the forms of organised trading that are already taking place in the OTC market through inter dealer brokers on the dealer-to-dealer market; and through various dealer to client platforms (such as Bloomberg, TradeWeb). Finally, we have noted that the forces of competition and innovation are already ensuring that the OTC derivative markets are naturally gravitating towards more electronified forms of trading where demand exists.

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

In this context, we interpret organised trading venues in the wider sense of the concept rather than discussing exchange trading only. We firmly believe that progress towards greater levels of organisation – movement along the multilateral range of the execution continuum where appropriate with increasing level of electronification – is best achieved through allowing the market to innovate in the execution space.

We have outlined the regulatory tools that we believe will be the most effective in allowing regulators means to accurately monitor market activity and overall exposures. An appropriately calibrated post-trade transparency framework and trade repository reporting, and the generally greater accessibility of data through increased level of electronification, will allow regulators to access overall liquidity information and adjust capital requirements according to defined measures of transparency and liquidity. We believe that full assessment of the liquidity impact of any transparency framework must be conducted prior to implementation, and will be keen to work with CESR and the European Commission in such an effort.

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 strongly support any regulatory action to reinforce competitive standards to the extent regulators identify that market-led evolution of organised forms of trading create monopolies or other competitive distortions.

To the extent that this is not the case, we strongly believe that any attempt to impose a level of organisation on a specific market will lessen that market's efficiency and have no additional benefits in terms of stability. Such actions are likely in our view to have a material impact on liquidity, and transaction costs, and collectively, upon the economy. Fundamentally, any perceived benefit from a specific policy action, must be weighed against the potential cost. In this case, the relevant cost benefit analysis should take into account the benefit to the market from ensuring versatility of the pre-trade and execution framework (which for OTC derivatives is significant), weighed against the risk of unfavourable outcomes to retail participants (which for OTC derivatives is negligible or not applicable due to absence of retail participation). Therefore we do not see a case for regulatory action in this space, although we welcome continued combined industry and regulatory efforts to achieve consistent transparency, infrastructure, and legal standards in OTC derivatives.

Question: posed at the open hearing and circulated subsequently by Mr. Alberto Garcia, CESR Secretariat.

A key element for standardisation is uniformity, namely in respect of legal documentation, of product specifications and of processes. For standardisation of derivatives, uniformity in post-trade processes is a pre-requisite. For example: derivative contracts with exactly the same contract specifications are being traded on more than one trading platform. A change might occur with respect to the underlying of the derivative contract due to e.g. liquidation of the issuing company or in case of

dividend payments. Consequently, such a change will have an impact on the contract specifications of the derivatives and on the clearing and settlement of these derivatives. Another related example would be whether handling of corporate actions by trading platforms on which the same derivative contracts are traded, would need to be aligned

However, it seems that if the handling of the consequences of such changes in the underlying is not standardised and differs for transactions in the derivatives concerned on various exchanges, the fungibility of the derivative contracts will be jeopardised as a result.

The question would be:

1) Whether this situation is detrimental to the objectives mentioned of improved risk management, increased transparency and reducing systemic risk, and
2) Whether to avoid such negative consequences, it would be advisable to ensure e.g. through adequate coordination between relevant stakeholders (regulators, trading platforms concerned, investor advocacy groups, etc.) agreement on an uniform handling of such changes/developments relating to an issuing company that will impact the post-trade processes (e.g. clearing) of the relating derivative contracts. An additional topic to consider in this regard is whether this would also help the interoperability between CCPs in general.

Response:

We believe that ensuring uniformity in contracts post-trade behaviour (including in the application of specific post-trade events) is an important part of systemic risk management. This is particularly relevant as OTC derivatives are introduced to CCP clearing.

More specifically,

- 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 (the "Supplement"). The Supplement the Determinations Committee makes all key determinations relating to the CDS contract such as whether a credit event has occurred; a succession event (relating to corporate activity) has occurred; a particular debt instrument is deliverable and the type of settlement to occur (usually an auction).

- 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. Consequently affected trades have a uniform observation period.

- The Supplement enhances the high level of standardisation that existed in the CDS market contract previously.

- Standardisation has been extended to clearing platforms, which for CDS trades incorporate the original market standard terms and the Supplement. Trades

executed with different counterparties or cleared with different platforms perform consistently because key determinations in relation to a CDS contract are made by one body (the Determinations Committee). Operational flexibility (in relation to issues such as partial triggering) is nevertheless preserved. Importantly, the combination of this standardisation and uniformity ensures that a market maker who sits between two OTC counterparties, two clearing counterparties or a combination of the two has the same standard trade terms on either side.

- In the context of CCPs and, as noted in our response to Q5 above, we believe that the market for clearing of OTC derivatives is and will become increasingly competitive. For example in the CDS space, there are offerings from CME, ICE, EUREX, LCH and potentially more CCPs on the horizon. In the case of the Rates products LCH, CME and potentially others are offering OTC clearing for interest rate swaps. Some of these clearing houses are also working on offerings for foreign exchange products, and others are working on clearing equity derivatives. Many of these entities are commercially driven for-profit enterprises. The concept of clearing concentrates rather than eliminates systemic risk by centralising counterparty risk into a central location. It is imperative that risk in the system is not increased through CCP risk management practices that do not ensure sufficient financial safeguards to manage safely counterparty defaults. To this end, the market would benefit from standardisation of a minimum set of robust legal, regulatory, financial and operational requirements. Each CCP could create customised solutions as long as these meet these minimum requirements.

- The equity derivative market, developed, in part, in response to demand from customers and dealers for alternatives on treatments of corporate actions not available in the listed equity markets. The ability to tailor corporate action treatment to mitigate unique risk is vital to ensuring maximum liquidity in the equity derivative market. As we look to increase standardisation in order to reduce systematic risk, it is important not to ignore the reasons behind why the customised event handling exists in the first place.

Appendix

ISDA Analysis, provided to the U.S. Federal Reserve Board

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1. Standardisation in the derivative markets
2. Credit – Legend for standardisation template
3. Credit – Standardardisation matrix
4. Equity – Legend for standardisation template
5. Equity – Standardardisation matrix
6. Rates – Legend for standardisation template
7. Rates – Standardardisation matrix