Investment Management Association

Standardisation and exchange trading of OTC derivatives

INTRODUCTION

1. The Investment Management Association ("IMA") welcomes this opportunity to submit evidence on the Committee of European Securities Regulators' consultation paper on *Standardisation and exchange trading of OTC derivatives*, published on 19 July 2010.

2. The IMA represents the UK-based discretionary investment management industry. Our members include independent investment managers, the investment management subsidiaries of retail and investment banks, managers of occupational pension schemes and managers of authorised funds (collective investment schemes). Our members are responsible for the management of about £3.4 trillion of assets owned by underlying clients based globally, including pension schemes and individual investors.

3. Our members' interest is as users of derivatives and derivatives markets on behalf of their underlying clients. A significant factor in the management of client assets is to ensure the long term security and growth of investments and savings. In that regard, investment managers' interest is in market stability, but also in competitive choice and cost effectiveness within a market. Usage of derivatives will be within the range of pure hedging, EPM (efficient portfolio management), and for risk management and liability matching purposes.

GENERAL COMMENTS

4. We believe the time frame for introducing product standardisation is likely to be years rather than months if proper consideration is to be made of all the relevant issues. These issues include legal (contractual rights, property rights, trust arrangements), operational (systems, operational certainty, margining, contract portability, client and regulatory reporting) and trading (derivative structures, cost).

5. Much of the benefit of central clearing as it is currently arranged for OTC derivatives accrues to CCPs and dealers, not least as these are the parties specifying how the contracts should be handled. Regulators will also be substantial beneficiaries in terms of access to information. This is not as yet the case for end users. The benefits that can accrue from exchange trading relate to fungibility, transparency of price information, contractual design and certainty, and possibly liquidity. It is likely that the absence of exchange specified contracts has been one of the factors that contribute to end users' interests being poorly looked after. Indeed relatively little of the current legislative work is directed explicitly towards ensuring that investors are appropriately protected. Whilst at this stage we do not think it would be beneficial to force the issue of exchange trading, as the market is already dealing with a vast amount of change and therefore increased risk, we believe it merits further attention once the current round of changes settle down.

65 Kingsway London WC2B 6TD
Tel:+44(0)20 7831 0898 Fax:+44(0)20 7831 9975
www.investmentuk.org

6. Having said that, we note that the meaning of "exchange" trading has become somewhat confused post MiFID. Exchanges have seen a reduction in their role in traditional exchange-traded markets, such as cash equities, as new entrants have come into the market such as MTFs. It is not enough to specify exchange trading without considering the range of what is permitted in other markets and how the various platforms interact, and indeed what the full range of regulatory requirements should be on the exchanges in relation to monitoring OTC derivatives markets for abuse.

7. A remaining concern (alluded to in paragraph 5) is that regulators appear to have drawn little distinction between the service providers – banks, dealers, brokers, trade repositories – and market users. End users have their own business which is entirely distinct from that of the market service providers. This results in a mismatch in terms of resource between the service providers and the users: as there is, by analogy, between supermarkets supplying food and individuals purchasing it. Regulators need to take more account of this mismatch in resource and interest. Clearly, the sell side of the market is well resourced to explain its own business. Markets users by contrast are a highly fragmented group. The difficulties associated with analysing their interests should not mean that they are of less consequence than those of the service providers.

8. Our responses to the specific questions raised follow.

STANDARDISATION

Q1: Do you agree with CESR's assessment of the degree of standardisation of OTC derivatives? Is there any other element that CESR should take into account?

Broadly yes, we agree. We make 3 further points:

i. In paragraph 7 CESR identifies 4 uses for derivatives – hedging, funding, speculation and arbitrage. We are not sure what "funding" is exactly meant to cover. We consider that the following uses should also be included in the list: EPM (efficient portfolio management), risk management and liability matching.

ii. It is important that "standardised" products continue to offer the necessary flexibility around tenors, coupons and maturity dates, in particular for interest rates and FX derivatives.

iii. Many of the benefits identified now accrue to regulators rather than market participants and end users. Whilst we agree that better information and risk management needed to be introduced to the markets, there has been progress in the last two years. It is important that the balance of interests is kept on the side of the needs of end users, without whom markets have no life.

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?

Broadly yes, we agree.

We have commented before on the certain need for some bespoke contracts, and believe that CESR understands the position.

As mentioned in our general comments, we hold the view that central clearing for bi-lateral contracts is a somewhat artificial process, imposing as it does an after the event interpretation of what should be standardised, rather than starting with a contract specification which parties have chosen to trade, clear and settle. This reality will add considerable stress to the process during the early phases of standardisation.

The amount of regulatory change underway in the industry has already stretched resources for all market participants. Industry-led vendor solutions are still yet to resolve many of the issues raised under the CCP initiatives and, due to inconsistency in approaches between the CCPs, will cost the end investors more to implement. In addition, sufficient time should be allowed to implement new systems: the buy side of the market has to wait until the sell side and the CCPs have completed their work before making their own decisions. We do not see anywhere that this timing mismatch has been recognised or addressed. As we have said before, it would be rash and counter-productive to fail to give the client side of the market the same attention as the market service providers (banks, CCPs, trade repositories).

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

Yes, if well done, and preferably by allowing the market to take the work forward (subject of course to the work progressing to a reasonable timetable). The aim should be to ensure that the standardised contracts are fungible (therefore truly standardised).

There remains considerable uncertainty at present in respect of legal and operational issues in most areas of clearing for OTC derivatives, including of course the regulatory regime within which the CCPs will operate. All such issues will have to be concluded and will need to offer a very high degree of certainty of outcomes for all market participants before standardisation can be said to have been achieved. To summarise, the issues that remain open include legal certainty (concerning contractual, property rights, trust arrangements), operational risk (systems, segregation, margining and collateralisation, contract portability, client and regulatory reporting) and trading (derivative structures, cost).

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

The regulators already have an existing pattern of working which should form the basis of future work – working with ISDA and the key banks and CCPs. However, the process is significantly deficient in consulting the interests of end users of the market – whose interests should we believe be paramount in regulatory terms. Regulators are able to contact buy side firms, corporates, and the various trade associations that represent these groups, but make virtually no effort to do so. We urge regulators to try and correct this imbalance in interests.

It is important to ensure that enough time is given to consult properly – this consultation, for example, carries a short timeframe for responses over the holiday period. it would have been helpful if more notice could have been given of the intention to consult.

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

We repeat our earlier point: regulators need to do more to consult the interests of the end users of the market and take note of their comments, on a running basis, on standardisation of particular contracts. End users benefit from standardisation more than market service providers such as banks and as such their interests are likely to be closer to those of the regulators.

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

Regulators should prioritise those products which have already been identified as capable of standardisation (permitting timely electronic confirmations, greater use of STP, adoption of standard contract terms and standardised definitions). It is not an easy task to move products from one form of clearing to another. Rather than attempting to tackle many asset classes and product types we would prefer to see focus on a few, to allow the market to get these right and sort out issues arising, then put the knowledge gained to work for other asset classes.

Q7: CESR is exploring recommending to the European Commission the mandatory use of electronic confirmation systems. What are the one-off and ongoing costs of such a proposal? Please quantify your cost estimate.

CESR should be careful of introducing barriers to entry in the market. Therefore, whilst we support the use of electronic confirmation systems in general, we would not expect regulators to specify how exactly these might work – the market should be allowed time to come up with a range of solutions suitable for all their clients. It would be counterproductive if smaller end users were to lose the ability to hedge their business because regulators had required mandatory two-way electronic confirmations.

EXCHANGE TRADING

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?

The assessment does not articulate how CESR sees the process to bring contracts into exchange trading occurring in practice. This is an essential missing element. Without it, we believe the assessment is somewhat artificial. It treats exchange trading as an after the event addition to the process of central clearing, whereas more usually exchange trading is the start of the process to introduce new products. It is for this reason that we support the view that it would be better to let the market take its course.

In addition, however, we note that the absence of exchange trading does continue the current mismatch in information flow between the market service providers – banks, CCPs, trade repositories – and end users.

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

We have nothing to add to our answer to question 8.

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.

This is a highly complex question – and there is much academic research which illustrates this published for existing exchange markets, cash equities in particular.

There is a fine line between too much and too little information in a market, and the impact this may have on liquidity: too much is a disincentive to trade, most particularly in dealer markets; too little creates an expensive imbalance for end users. However, liquidity is not driven merely by transparency – there has to be a natural level of trading in addition.

As regards this work, we repeat that we believe it would be better to concentrate on central clearing for a few products at a time, leaving the question of exchange trading to be determined at a later date when the market has resettled.

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

Exchanges and their members have to be willing to trade the contracts specified. If there is no meeting of minds on the feasibility of trading a particular contract, then the contract is unlikely to be successful. See also question 12.

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

Exchange platforms are open for trading their contracts throughout the specified hours, regardless of actual volumes which can vary enormously consequent on timing and external events. Natural liquidity (buy and sell interest) is enormously helpful but of itself does not define the market. Therefore we would not agree that a level of liquidity should be set for considering the introduction of exchange trading. Standardisation should, we suggest, focus on the ability to produce fungible contracts, rather than liquidity per se. Where contracts are truly fungible, the conditions for introducing exchange trading are met, even if not the appetite.

Q13: Do you agree with CESR's assessment of the characteristics and level of standardisation which are needed for a contract to be traded on an organised trading platform?

We are pleased that CESR recognises (in paragraph 83) that a high degree of standardisation may not be sufficient to successfully support trading on organised platforms and we would give the example of OTC property total return swaps which are relatively standardised but not necessarily suitable for trading on organised platforms due to low volume and liquidity.

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

No, we do not consider that the availability of CCP clearing is essential. There are single dealer electronic platforms operating currently and these do not link to CCPs. It is not impossible for exchanges to handle settlement without use of an external CCP. That having been said, the presence of a CCP is a very substantial aid to centralising/formalising trading through an exchange platform.

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

Yes, a very important element. Without fungibility it is difficult to sustain continuous trading of a contract (note that this is not a comment on the level of trading that actually occurs). Lack of fungibility would require individual listing of contracts which is complex and unlikely to support a bringing together of what liquidity is in the market at any point in time.

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

As mentioned previously, we believe it is best to let this evolve as the central clearing of contracts beds down.

Otherwise we suggest the next contract to be considered should be CDS indices, as these are already fairly well standardised, generally highly liquid and could be constructed to provide fungible contracts.

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.

We have no specific comments to make.

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.

The requirements in both paragraphs are relevant, although we note that these deal with how an exchange should approach its business, rather than whether that business is in fact providing a trade platform for OTC derivatives.

We note also that the meaning of "exchange trading" has become somewhat confused post MiFID. Stock exchanges have seen a reduction in their role in traditional exchange-traded markets, such as cash equities, as new entrants have come into the market such as MTFs. It is not enough to consider "exchange trading" without also considering the range of what is permitted in other markets and how the various platforms interact. It is not clear, for example, whether the references to "exchange trading" for OTC derivatives are intended to imply that only an exchange platform will be available for trading or whether, as with cash equities, a range of different platform types may be offered.

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.

Whilst current trading models and trading platforms can no doubt make pricing information available on a multi lateral basis, we would draw your attention to two important factors that regulators should consider before reaching conclusions:

i. The severe and damaging impact for end users of the equity market consequent on the data fragmentation that arose post-MiFID. Fragmented data offers relatively speaking so little value that to set up a model that follows this would be an expensive and pointless exercise.

ii. If the issuance of data is not specified and controlled carefully then end users may find that their positions are exposed, and thus subject to gaming by other market participants. This is likely to have a knock-on impact not just in respect of trading activity, but also to the ability to value positions for example for the purposes of daily valuations for authorised UCITS funds.

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

No. We believe that the SI regime has not been a success for cash equities, has given rise to behaviour designed to avoid the problems inherent within the SI regime, and has been one aspect of the MiFID arrangements that acted to reduce market transparency rather than increase it.

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?

We do not consider that the SI regime has provided the benefits described. Nor do we believe that the SI regime provides an appropriate model for OTC derivatives trading. Whilst the theoretical economic rationale can be understood, in practical terms the SI regime is highly unattractive to OTC dealers since it specifies rigid criteria with no proper framework in which the dealer can obtain the necessary protections for running his book. It is also possible effectively to avoid some of the requirements, for example by quoting in single share size.

Q22: Which characteristics should a crossing network regime, as envisaged in the review of MiFID, have for a crossing network to be able to be qualified as a MiFID "organised trading venue"?

We do not believe that crossing networks are the same as "organised trading venues" in MiFID, in part because of the lack of transparency in the network. We see crossing networks as more akin to a specific client service, used from time to time, rather than an approach to trade in the open market that is provided by an organised trading venue.

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?

Whilst it would be advantageous if the US and EU regimes could be similar, in practice the existing organised markets in the two regions have always had substantial differences between them and to our best knowledge this has rarely produced regulatory arbitrage. From an end user perspective, we would be most comfortable if both market regimes promoted high standards intended to protect investors. Our concern is that the process in both regions has taken little account of the end user interest.

Q24: The Commission has indicated that multi-laterality, pre- and post-trade transparency and easy access are key aspects of the concept of "on exchange" trading. Do you agree with CESR applying these criteria in its further analysis of what this means in the EU context, in particular in applying MiFID to derivatives trading?

Yes, we agree they should be key aspects to consider in moving OTC derivatives to exchange trading.

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 think this is not necessary.

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

We are not aware of any. This in part probably reflects the resource diversion to bringing in central clearing.

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

We consider that an appropriate incentive would be the provision of lower capital requirements in respect of derivatives trades on organised trading venues, also taking account of whether the exchange traded contracts are also centrally cleared.

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 believe that it is appropriate to take mandatory regulatory action whilst the process of bringing more contracts into central clearing is underway. It could prove to be a significant distraction from the main task without immediate benefits. Once fungibility of contracts is achieved, and there is more experience of clearing OTC products, regulatory action may be helpful if there is no move within the market to introduce exchange trading.