

**STANDARDISATION
AND EXCHANGE TRADING
OF OTC DERIVATIVES
CONSULTATION PAPER (CESR/10-610)**

COMMENTS BY AMAFI

1. The Association française des marchés financiers (AMAFI) has more than 120 members representing over 10,000 professionals who operate in the cash and derivatives markets for equities, fixed-income products and commodities. Nearly one-third of the members are subsidiaries or branches of non-French institutions.

AMAFI has looked closely at the consultation paper on Standardisation and Exchange Trading of OTC Derivatives published by CESR on 19 July. Responses to this paper are required by 16 August. This is an extremely important topic that raises many issues. And although these include the urgent need, highlighted by the crisis, to enhance the prevention of systemic risk, any solutions must not unduly affect the ability of derivatives markets and their participants to provide clients with the risk-hedging instruments that they are entitled to expect. The huge expansion of the OTC derivatives market described by CESR cannot be solely attributed to the arrival of speculators. Rather, it primarily reflects the determination of an ever-widening group of economic agents to hedge or diversify their risks, coupled with the capacity of market participants to provide products that can cover increasingly specific and diversified risks.

2. Given these issues, AMAFI is deeply disappointed that CESR chose to hold its consultation in the middle of the summer, when many of the association's talking partners, who could have helped to inform its thinking, are on holiday. This prevented AMAFI from carrying out the necessary in-depth analysis, identifying solutions and holding discussions. Accordingly, some of CESR's questions are touched on very briefly or not addressed at all.

While it is understandable that a certain urgency is attached to this question, which is a focus of attention for G20 governments, it is nevertheless a great pity that CESR did not see fit to warn stakeholders about this forthcoming consultation and its short feedback period, to give them an opportunity to organise themselves. If CESR wants a useful, high-quality consultation process, it should be in a position to provide a frequently updated six-month consultation timetable, especially now that we are seeing so many consultations, with ever-shorter deadlines, a point made by EFSA¹ at the beginning of the year.

¹ See letter to Mr Carlo Comporti, 29 march 2010, <http://www.efsa-securities.eu/Letter%20to%20Carlo%20Comporti>.

3. While it is undeniable that standardisation is a prerequisite to the trading of derivatives on trading platforms, standardisation and platform trading are still two different things. There seems to be an intellectual bias to CESR's presentation, insofar as all the benefits of standardisation listed in the paper flow primarily from standardisation itself, without being in any way linked to the fact that the products in question are also traded on organised platforms (*see also § 14 below*). Thus, aside from the "Facilitates the use of electronic trading venues" factor, which obviously does not correspond to the point of this analysis, all the other benefits listed in paragraph 39 of the consultation paper may also be obtained with OTC trading:

- Operational risk reduction
- Facilitates the use of clearing
- Ease of unwind
- Facilitates the reporting of information for regulatory purposes
- Enhances contractual certainty
- Increases pricing comparability due to transparency based on standardisation
- Improves information sharing (particularly for regulators)
- Improves the meaningfulness of information (of positions from a trade repository).

By contrast, the potential limitations of standardisation listed in paragraph 40 are direct obstacles to the trading of certain derivatives on organised platforms.

4. In recent months, the industry, acting through the ISDA and in partnership with regulators, has already accomplished, and continues to do, major work on standardisation in the following areas:

- Publication of new master confirmation agreements for equity derivatives
- Implementation of the Small and Big Bang Protocols for the credit derivatives
- Electronic confirmation targets monitored by supervisors
- Underlying definitions
- Confirmation templates and market practices with regards to post-trade and lifecycle events.

In this respect, it seems worth reiterating that this work is driven chiefly by the determination to reduce the risks associated with trading these products, rather than by the objective of prioritising trading on trading platforms going forward. For this, an objective assessment of the intrinsic benefits of using trading platforms versus an OTC approach still remains to be done. The CESR paper offers only a very brief and questionable assessment in this regard.

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?

5. At this stage, AMAFI does not have any particular comments to make about the elements provided in the table on pages 12 and 13 of the consultation paper.

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?

6. Subject to the above (*see § 3 and 4 above*), AMAFI does not have any comments to make on the benefits and limitations of standardisation noted by CESR.

However, it should be emphasised that the main limitation is connected with the increased uniformity that will inevitably arise from standardisation, which will reduce the ability of participants to offer products that

precisely cater to client needs. From this point of view, it is essential to conduct a rigorous analysis of the reasons why clients make so much use of OTC rather than platform-traded derivatives.

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

7. AMAFI believes that greater standardisation is desirable to the extent that it is a key factor in reducing systemic risk, notably because it is a prerequisite to the efficient interposition of clearing houses. This is the primary challenge and objective of standardisation. But standardisation is also desirable insofar as it helps to enhance market transparency and oversight.

However, these benefits have to be weighed against the need among clients for products that allow them to hedge or diversify risks as effectively and cheaply as possible. Failure to do so could lead to European participants being prevented from offering suitable services, which could impact Europe's GDP and have consequences in terms of controlling an activity that is vital to the growth of the European economy.

8. For this reason, it is essential to take a pragmatic approach to this issue, notably by conducting a separate analysis for each asset class.

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

9. Given the conditions under which this consultation was held (see § 2 above), AMAFI is disappointed not to be able to give a precise answer to this question.

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

10. Given the conditions under which this consultation was held (see § 2 above), AMAFI is disappointed not to be able to give a precise answer to this question.

It notes, however, that the UK authorities recently produced a report underlining the difficulties of taking regulatory action in this area².

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

11. Given the conditions under which this consultation was held (see § 2 above), AMAFI is disappointed not to be able to give a precise answer to this question. It stresses, however, that given the wide variety of products concerned and the needs that they address, it is hard to imagine adopting an overall approach rather than a class-by-class approach. In this approach, regulators should focus on the asset classes that present the greater systemic risk in terms of size and volatility.

² *Reforming OTC Derivative Markets - A UK perspective*, Financial Services Authority & HM Treasury, December 2009.

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.

12. Given the conditions under which this consultation was held (see § 2 above), AMAFI is disappointed not to be able to give a more precise answer to this question.

Nevertheless it is important to bear in mind, however, that the issue of using electronic confirmation systems is not specific to the derivatives market but concerns all financial transactions. Since these tools entail significant introduction and usage costs, their appeal is thus directly linked to the trading volume of the participant, which is why electronic confirmation systems are already widely used by the main participants on these markets, whether they are financial intermediaries or end users. But many of the participants that do not use these systems have business volumes that are too small to justify the costs of such an investment. Forcing them to use electronic confirmation systems may cause them to turn away from products that are useful to the proper conduct of their business or, more likely, to "acquire" them from counterparties that are not subject to European regulations.

13. Furthermore, the plethora of existing electronic confirmation systems is not helpful in rationalising and lowering costs. Accordingly, it would be useful to conduct standardisation work in this area.

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?

14. Generally speaking, AMAFI basically shares CESR's assessment. However, it feels that the possible introduction of a requirement to widely trade derivatives on organised platforms should not be based on such a weak analysis, especially since the European Council, Parliament and Commission came to exactly the opposite conclusion a few years ago after a far more thorough analysis. MiFID, which came into force in November 2007, is predicated on the notion that there are far more benefits than drawbacks to having full competition between different trading approaches, i.e. trading on organised platforms (regulated market and MTFs) and direct trading with financial intermediaries (OTC).

Something more than two pages of analysis is necessary to appropriately support the conclusions that CESR appears to be favouring. In addition, more detailed arguments need to be put forward on why an analysis of derivatives should not also hold for other financial instruments...

15. As regards the specific question of market transparency, AMAFI stresses that this is a particularly complex issue. For one thing, the ability to easily organise high-quality post-trade transparency for transactions on trading platforms does not mean that it is in principle impossible to do the same for OTC transactions. Pre-trade transparency, meanwhile, is not always desirable, as CESR itself has pointed out more than once.

Given that there is nothing to stop organised platforms from doing as much derivatives trading as they please, why have the benefits noted by CESR not caused volumes to concentrate on these platforms?

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

16. Given the conditions under which this consultation was held (see § 2 above), AMAFI is disappointed not to be able to give a precise answer to this question.

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.

17. As previously mentioned (*see § 15 above*), transparency can also be delivered off trading platforms. Moreover, while transparency can be a factor in liquidity, it is also based on liquidity: transparency for a non-liquid instrument makes no sense and provides no benefits.

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

18. Given the conditions under which this consultation was held (*see § 2 above*), AMAFI is disappointed not to be able to give a precise answer to this question.

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

19. If the question is based on the notion that beyond an as-yet-to-be-determined level of liquidity transactions could be directed solely to organised markets without interfering with market efficiency, AMAFI does not see how to provide a response, especially a uniform one with no distinction by asset class.

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?

20. This is an odd question. A contract traded on an organised platform is by nature necessarily standardised: anyone who wants to trade this contract may do so (potentially indirectly through a platform member), but cannot change any of the characteristics.

Furthermore, in the context of a discussion on "repatriating" OTC-traded products to organised platforms, it would be useful to take a more in-depth look at the issues linked to the intellectual property rights attached to many of these products.

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.

21. As indicated earlier (*see § 7 above*), AMAFI believes that the primary challenge and objective of standardisation is to reduce systemic risk, by enabling the efficient interposition of clearing houses. Even for financial instruments that are traded 'off-exchange', centralized clearing is the fundamental point.

In any event, it is unlikely that there would be enough appeal for participants to have their transactions carried out on organised platforms if these did not provide them with adequate post-trade systems, notably in terms of counterparty risk reduction.

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

22. Once again (see § 20 above), this is an odd question. By nature, a contract traded on an organised platform is necessarily fungible with all other contracts of the same type. The underlying idea of trading a single contract linking only two counterparties on an organised platform does not make sense.

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

23. Given the conditions under which this consultation was held (see § 2 above), AMAFI is disappointed not to be able to give a precise answer to this question.

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.

24. The real question is why clients that already have the option of using an organised platform do not do so more extensively.

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.

25. Although MiFID encompasses a broad spectrum of financial instruments, its architecture as regards markets and their organisation was primarily designed with the equity market in mind.

Using the MiFID framework for platforms trading derivatives products is especially debatable since work is underway to correct some of the directive's unforeseen and undesirable effects on the equity market.

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 multilateral basis? Please provide examples, including specific features of these models/platforms.

26. Of course. For example, sell-side already offers pre-trade transparency in CDS/Index CDS, either through voice or quotes/runs/axes in electronic format. Two types of price information are currently available to participants in the European CDS market: dealer quotations and dealer average/consensus prices. Brokers and wholesale banks are a significant source of pricing information for their clients.

Electronic platforms put in place tools to enable investors to trade bid lists electronically by putting various sell-sides in competition (e.g. QWIXX). This information is available on a multilateral basis to users.

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

Q21: If so, do you consider that the current SI-regime provides the benefits described above which ‘exchange trading’ may offer or are amendments needed to the SI obligations to provide these benefits to the OTC derivatives market?

27. Applying a MiFID framework seems particularly inappropriate given that work is underway on adjusting the SI regime in response to criticism (*see also § 25 above*).

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”?

28. Given the conditions under which this consultation was held (*see § 2 above*), AMAFI is disappointed not to be able to give a precise answer to this question.

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?

29. It is impossible to respond to this question, not just because the consultation period was too short to conduct the necessary analysis, but also because only the legislative part of the reform has been carried out so far. Financial regulators, particularly the SEC and CFTC, still have much regulatory work ahead of them.

In any case, it is obvious that regulatory arbitrage will occur because of differences between the US and Europe. Additionally, we should not overlook the fact that arbitrage might also involve other countries, particularly in Asia. Furthermore, this question does not merely involve potential regulatory arbitrage, but also eventual conflicts of law.

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?

30. For the reasons given above, AMAFI does not believe that these criteria, especially when described so schematically, provide an appropriate framework for analysis.

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.

31. As indicated earlier (*see § 25 above*), MiFID needs to be adjusted to suit the specific characteristics of derivatives markets.

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

32. Given the conditions under which this consultation was held (see § 2 above), AMAFI is disappointed not to be able to give a precise answer to this question.

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

33. The real question is whether market participants, and especially end clients, can benefit, in which case trading will naturally tend to concentrate on organised platforms.

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.

34. Given the conditions under which this consultation was held (see § 2 above), AMAFI is disappointed not to be able to give a precise answer to this question.

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