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CESR
The Committee of European Securities Regulators

Submitted via www.cesr.eu

**Standardisation and exchange trading of OTC derivatives**

London, August 16th, 2010

Dear Sirs,

MarkitSERV welcomes the publication of CESR's Consultation Paper on *Standardisation and exchange trading of OTC derivatives* and we appreciate the opportunity to provide you with our views on this topic.

On September 1st 2009, after receiving regulatory approval from the Department of Justice in the United States, and the Financial Services Authority (FSA) in the United Kingdom, Depository Trust and Clearing Corporation (DTCC) combined its post-trade confirmation platforms for OTC derivatives with Markit's trade processing services. The resulting joint venture, which is called MarkitSERV, provides an integrated multi-asset class Trade Processing Facility for the global OTC derivatives markets.

Whilst in the early days of the OTC derivatives markets, counterparties to a transaction legally confirmed their trades by fax, mail, email and other means, electronic confirmation platforms are now the de facto standard for confirmation processing and the engine driving operational efficiency and risk mitigation. Once OTC derivatives transactions have been electronically confirmed, these platforms can communicate the transaction details to all other parties that are relevant in the post-trade work flow, thereby dramatically reducing the dependency on manual processes and improving the accuracy, efficiency, timeliness, and security of OTC derivatives transactions. Electronic confirmation platforms are widely used today and market participants are committed to further increasing their use for eligible trades with the aim of electronically confirming most OTC derivatives transactions on trade date.

MarkitSERV handles the confirmation and processing of the majority of electronically confirmed OTC credit, interest rate, and equity derivatives transactions globally. Over 70 dealers, more than 70 interdealer brokers, and over 1,800 buy-side clients, consisting of more than 19,000 individual fund entities, now feed their trades into the platform, which in turn is connected to the major CCPs as well as to Trade Repositories to provide them with details of confirmed trades.

We feel well positioned to provide you with our comments related to the standardisation and exchange trading of OTC derivatives. Please do not hesitate to contact us if you require any additional information.

**Questions 1 to 3**

- **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?**
- **Do you agree with the benefits and limitations of standardisation noted above? 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? Do you agree that greater standardisation is desirable? What should the goal of standardisation be?**

We generally agree with CESR's assessment of the degree of standardisation of OTC derivatives, the description of its benefits, and the split into legal, process, and economic standardisation. That said we feel that a couple of statements would benefit from an update or clarification:

- The statistics that were used to describe the level of electronic confirmation of OTC derivatives only reference the year 2008. It is worth pointing out that the extent of electronic confirmation has increased significantly since to currently 99% for credit derivatives, 78% for interest rate derivatives, and 32% for equity derivatives respectively[1].

- Whilst the CP states that electronic confirmation for equity derivatives was limited to standardised products, interdealer and large buy-side, it is also provided for more exotic products such as barrier, knock-in/knock-out options, dispersion swaps and others. The requirement for firms to execute additional Master Confirmation Agreements for these products to reflect regional and exchange differences, however, has led to longer lead times of implementing an electronic solution. The firms' legal, operational and technical resources have therefore been focused mainly on standardised equity products.

We are of the opinion that for OTC derivatives not all forms of standardisation are equally desirable as the flexibility and ability to customize these products in order to match specific risk management needs of users - i.e. their lack of economic standardisation - is one of the major reasons for their existence. Regulatory efforts, we believe, should focus on encouraging further legal and process standardisation, as the existence of those will provide most benefits of standardisation in creating reliable and robust markets. In contrast, we believe that regulators should avoid mandating economic standardisation for these products. Given the value and in some cases necessity for many users for customisation, it should be left to the market to decide the extent of economic standardisation of OTC derivatives.

**Questions 4 and 5**

- **How can the industry and regulators continue to work together to build on existing initiatives and accelerate their impact?**
- **Are there any obstacles to standardisation that could be removed by regulatory action?**

Whilst direct regulatory intervention may not be uniform, input from regulators to standardise has been a significant factor in encouraging industry participants to focus resources on working through complex legal issues in order to standardise legal and process aspects of OTC derivatives. Continued regulatory focus will help ensure that as products develop, legal and process standardisation can continue to occur in a timely manner. The industry and regulators should therefore continue to work together to build on existing initiatives and accelerate their impact by increasing the commitments and communications by relevant functional areas such as increasing legal standardization, reducing operational inefficiencies, and greater use of technical solutions to greatly increase the speed, scope, and accuracy of build to reach the goals of efficiency, transparency and resiliency.

In our opinion the major obstacles to further legal and process standardisation for OTC derivatives are the nature of many market participants, e.g. infrequent users or market participants that are located outside the major regions, the complexity of products, and the lack of trade frequency. The impact of the first factor

[1] Markit Metrics Q2/2010 Quarterly Trend Report data for the G14 group of dealers, see www.markit.com for further details.

could certainly be reduced if global regulators in their entirety reached consensus on process standardisation, e.g. mandated use of confirmation platforms where they exist for the products, especially where the use of electronically confirmed transactions seems less pronounced such as in some emerging markets countries or for certain groups of market participants.

**Question 6: Should regulators prioritise focus on a certain element of standardisation and/or a certain asset class?**

As outlined above we are of the view that the regulatory focus should be on further legal standardisation of OTC derivatives, which will allow process standardisation to follow. It is important to hereby take the significant differences between asset classes into account as has already been reflected in the various industry commitments. We agree with the view that the degree of standardisation differs by asset class and greater legal and process standardisation is possible because of the existing legal and technical architecture of confirmation platforms. However, the continual emergence of new products in the OTC derivatives market creates a situation whereby complete standardisation will never be possible or desirable, whilst efforts for greater legal certainty are achievable (please see our comments related to the provision of authoritative transaction records below).

**Question 7: 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?**

Over recent years significant regulatory pressure has been exercised on the industry with the goal of eventually achieving T+0 electronic confirmation of all OTC derivative transactions across the major asset classes. Significant progress has been made by the industry to date and commitments have been given to improve confirmation performance further. It is widely viewed that electronic confirmation is considered best practice for most OTC derivative transactions already. That said we would urge CESR to take the definition of “electronic confirmation” and the impact on various user groups into account when considering a mandatory use of electronic confirmation systems:

**Narrow vs. broad definition of electronic confirmation**

- Mandating electronic confirmation in the narrow sense, i.e. requiring the confirmation of all trade details in a legally binding fashion, should represent the ultimate goal in order to minimize legal risk in the OTC derivatives markets while maximizing their efficiency. However, as you rightly point out, the pre-condition for achieving this goal is to actually make all transactions eligible for such confirmation, a task which does take time and effort. We are concerned that establishing a requirement for “full” electronic confirmation beyond the existing commitments risks shutting down activity in those products that still require additional work to become eligible for electronic confirmation. Also, it might not be cost effective to implement full legal standardisation and the ability to electronically confirm transactions in very exotic products that only experience a handful of trades each year. We therefore recommend a phased-in approach.

- CESR should only consider mandating electronic confirmation in a broader sense, i.e. require the creation of “authoritative” transaction records, pre-confirmation or “tie-outs” for products that are not currently eligible for electronic confirmation. Pre-confirmation, which is already successfully performed for a portion of the less standardised transactions today, consists of a comparison and confirmation of just the major trade details by both parties without attempting to confirm all details of the transaction in a legally binding fashion. Such requirement would help to reduce legal and operational risk for less standardised products, whilst their electronic trade capture would offer many of the advantages of standardisation, e.g. transaction reporting and information capture. In addition, the industry should continue its efforts to further increase legal standardisation of these products in order to allow their full electronic confirmation in the not too distant future.

**Impact on different user groups**

We encourage CESR to consider the impact that a mandatory confirmation requirement would have for different groups of market participants:

- The vast majority of interdealer transactions in credit and interest rate derivatives are already electronically confirmed, with a rising portion also for equity derivatives. Mandating the use of electronic confirmation services where available would mainly help to ensure continued high levels of take up for these users and asset classes.

- Higher volume end-users in Europe have also largely adopted electronic confirmation; the remaining participants in this segment could be encouraged to electronically confirm if it was mandated.

- For those market participants that might only execute one or two interest rate swaps each year such as some corporate end-users it has not really been practical to electronically confirm. Mandatory electronic confirmation could present them with a significant challenge and CESR should take into account that without the use of a de-minimis provision it might have the unintended consequence of discouraging these infrequent users from using OTC derivatives for the purposes of effective risk management.

**Question 8: 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 agree with CESR's observation that several benefits may apply for many exchange-traded derivative products and believe that exchange trading can be an effective method of trading products with appropriate characteristics. However, given the objectives of creating liquid and transparent markets, where participants can safely and cost effectively trade products that match their risk management needs, we think there are several additional important considerations:

- In most cases it is not exchange trading itself that creates liquidity but it is only the most liquid products that can be successfully exchange traded. In contrast, for those products that are less frequently traded, the over-the-counter market tends to provide the more appropriate and efficient manner of execution:

  - Over the years, the launch of many derivatives products for exchange trading has failed. The major reason for such failures seemed not to be the lack of product standardisation but their low trade frequency. An open-order book simply did not properly function as the most effective form of liquidity. This appears consistent with your analysis where you identify product liquidity, the structure of market participants, and the size of the market as factors that are relevant for exchange trading, as all of those represent drivers of trade frequency.

  - Many derivative products, e.g. equity options, co-exist both in exchange- and OTC-traded format. For those products, market participants will be able to choose the most efficient way of execution and, in our experience, they will often do so depending on their trade frequency: actively traded shorter dated at-the-money products are mostly executed on exchange, whilst the less often traded products with long maturities and out-of-the money strikes trade mostly OTC.

  The risk of any regulatory push for exchange trading will be that, instead of increasing liquidity in the market place, it makes the execution of those products that are not suitable for exchange trading very difficult.

- Many benefits that are provided with exchange-trading are not unique to this specific form of execution. For example, as is the case for European equities or for corporate bonds in the US, an effective post-trade transparency regime can be implemented independently of whether the execution of transactions takes place OTC or on-exchange.

- Any regulatory push for exchange trading might entail a number of risks. Typically exchange trading consists of the listing of a product on a single exchange, and exchanges often offer not only execution but also clearing services. Mandatory exchange trading therefore runs the risk of encouraging the emergence of vertically integrated exchange monopolies, a situation that would not only reduce product choice and lower competition in the execution as well as in the clearing space, but could ultimately result in a significant increase of systemic risk.

**Questions 9 to 12, 16 and 17**

- **Which sectors of the market would benefit from/ be suitable for (more) exchange trading?**
- **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?**
- **Do you identify any other elements that would prevent additional OTC derivatives to be traded on organised platforms?**
- **How should the level of liquidity necessary/relevant to exchange trading be measured?**
- **Which derivative contracts which are currently traded OTC could be traded on an organised trading platform? 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.**

****Comment: in this consultation as well as in the open hearing it was unclear to us what CESR would actually regard as "exchange trading", and whether "exchange" would only consist of Regulated Markets, or would also include MTFs, RFQ mechanisms, single dealer platforms, etc. In order to be in a position to provide specific answers to your questions related to the benefits and risks of "exchange trading", we decided to use the notion that exchanges would only consist of Regulated Markets (RMs) and Multilateral Trading Facilities (MTFs).****

In our experience products need to be both highly standardized from a legal and from a process perspective, and also have a sufficient trade frequency to be traded successfully on RMs or MTFs, i.e. in an open-order book style. Amongst derivatives that currently trade only OTC, the on-the-run credit indices come to mind as products that might meet these characteristics. In contrast, most OTC derivatives, even those that are quite standardised, have a low trade frequency by their nature. For example, amongst the top 1,000 single name CDS, less than 100 trade more than 10 times per day across different maturities, according to data from the DTCC Trade Information Warehouse.

The OTC markets have proved to provide an efficient way of execution for large trades as well as in difficult markets. Mandating the execution of OTC derivative products on-exchange might have the unintended consequence of reducing the willingness of market makers to commit capital, resulting in further reducing their trading activity, particularly if full pre- and post-trade transparency was required. The potential damage to liquidity will increase with high trade size, low product liquidity, and increased market volatility. In addition, liquidity generally varies with the tenor of the trade, hence a one-size-fits-all transparency requirement does not even seem appropriate for a specific product, let alone an entire product category. Finally, the concepts of pre- and post-trade transparency cannot easily be applied to OTC derivatives given their heterogeneity and a range of additional factors that impact the prices at which individual transactions are concluded - such as counterparty credit risk.

All said we strongly encourage CESR to make use of transaction statistics for OTC derivatives in order to further analyse which OTC derivatives display a sufficient trade frequency and transaction size to qualify for "exchange trading" and/or additional transparency.

**Questions 13 and 14**

- **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?**
- **Is the availability of CCP clearing an essential pre-determining factor for a derivative contract to be traded on an organised trading platform?**

Whilst the most liquid OTC derivatives could potentially be exchange-traded even if they were not centrally cleared, clearing eligibility should tend to improve the likelihood of there being sufficient liquidity for open order book style trading. Central clearing helps to eliminate credit concerns that might exist related to individual counterparties and can therefore expand the potential pool of counterparties that are available for trading. A higher number of available bids and offers would improve the likelihood of these orders finding a matching interest to be executed. That said, the liquidity of products may vary over time and an OTC derivative that is clearing-eligible today may not be eligible in the future.

We believe that the universe of clearable and tradable products is not the same. Whilst some of the underlying factors that are required for clearing and trading eligibility, such as the legal standardisation of the product, are indeed the same, the existence of other factors will cause divergences between the two universes. One factor that is driving this divergence is the ability of CCPs to effectively risk-manage derivative positions in different asset classes:

- Plain-vanilla interest rate derivatives risk in one currency can be managed by a CCP on a portfolio basis, even if the portfolio consists of thousands of transactions that are all economically different and rarely trade. The universe of clearing eligible interest rate derivative transactions will therefore tend to be larger than the number of products that can be successfully traded on-exchange.

- In contrast, risk and correlation considerations tend to make it difficult for CCPs to centrally clear some Credit Default Swaps (CDS), e.g. those that reference sovereigns or market makers. Whilst some of these CDS are both standardised and trade frequently – and therefore potentially could trade on-exchange - they might not readily be clearable.

We therefore believe that regulators should generally de-link the determination of clearing eligibility from those of any potential trading and transparency requirements.

**Question 15: Is contract fungibility necessary in order for a derivative contract to be traded on an organised trading platform?**

Fungibility of financial instruments can come in different variations. Whilst an exchange-traded product will be identified by a single identifier and all positions are 100% fungible, fungibility in general does also exist for OTC derivatives, and one could argue that it might even surpass that of exchange-traded products:

- A standardised OTC derivative transaction, despite being a bilateral trade by its nature, can typically be novated to a range of other counterparties. Also, the fact that multilateral trade compression is successfully applied to OTC derivatives to remove economically redundant positions demonstrates that many existing transactions in OTC derivatives are directly or indirectly fungible.

- In contrast, whilst fungibility is indeed given for each individual exchange listed product, there is very little or no fungibility between economically equivalent products that are listed by different exchanges. If the future market structure contained multiple exchange-like platforms for the trading of products that are non-fungible between each other, i.e. a swap that is entered into on one platform cannot be exited on another, the available market liquidity would effectively be divided into smaller pools which may individually not have sufficient turnover to support clearing or electronic trading. This kind of structure would have the unintended consequence of significantly reducing the proportion of the market that is subject to the new safer paradigm.

**Question 18: 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?**

We believe that in addition to defining what constitutes a venue that can be used for "exchange trading" these venues should also satisfy a number of core principles. We would consider paragraph 86 to deal with the former, while paragraph 87 covers the latter. We believe it is a relevant consideration in this context that market participants in the OTC derivative markets are institutional while retail investors are not involved.

**Question 19: 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?**

Whilst we cannot comment on individual platforms, we note that the creation of transparency, be it pre- or post-trade, is in general not dependent on the form of execution. This can be seen both for European equities and for US corporate bonds that trade OTC to a significant extent whilst at the same time being exposed to effective pre- and post-trade transparency regimes.

However, attempting to create transparency directly from the various electronic trading platforms runs the risk of producing suboptimal results. As the post-MiFID experience for European equities has shown, competition in execution and the resulting data fragmentation can easily result in a significant reduction of transparency. Regulatory authorities should therefore consider early-on what kind of framework will be required to ensure the delivery of high quality, consolidated post-trade transparency to market participants at an affordable rate.

**Question 23: 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 the SEF definition that was used in the Dodd-Frank Bill seems to resemble the definition of an MTF in MiFID, it is not entirely clear yet how the U.S. regulators will actually interpret this definition. We believe that in order to ensure the continued functioning of the market it will be of crucial importance that effective ways of execution - such as request-for-quotes platforms - will be allowed to satisfy the Trading Requirement in the US. Whilst regulatory arbitrage would not be ideal, we believe that European regulators should work to implement an effective regime that supports an efficient, robust and organized market.

We note that US regulators have been provided with rule writing authority to define the classes of clearing eligible derivatives that can be traded, effectively allowing them to de-link the Trading from the Clearing requirement where they regard it appropriate. As we mentioned above, we are strongly in favour of providing such authority as it can play a crucial role to avoid unintended consequences and damage to liquidity.

**Questions 24 and 25**

- **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?**
- **If not, do you consider that MiFID requirements and obligations should be refined to cover deviating characteristics of other electronic trading facilities?**

We are of the view that the interpretation of any "on exchange" requirement should be wide enough to allow for a number of effective ways of executing OTC derivatives transactions as long as the desired requirements are satisfied. Request-For-Quote (RFQ) platforms for example should be allowed as they have not only proved to be an effective mechanism of executing transactions in products that rarely trade, but they also provide multilateral access to both buy- and sell-side participants, and can deliver both pre- and post-trade transparency in an effective fashion. That said any relevant MiFID requirements need to be refined in order to appropriately cover those platforms and reflect their specific characteristics.

**Questions 27 and 28**

- **Which kind of incentives could, in your view, efficiently promote greater trading of standardised OTC derivatives on organised trading venues?**
- **Do you believe there would be benefits in a mandatory regulatory action towards greater trading of standardised OTC derivatives on organised venues?**

Whilst we agree that exchange trading tends to provide a number of benefits for those products that trade actively, we are of the view that increased exchange trading of OTC derivatives should not necessarily be a goal in itself. Given that most OTC derivatives rarely trade, we are concerned that regulatory action to promote greater trading of these products on-exchange might result in them not being traded any longer. A preferable approach would be to allow trading on various effective forms of venues as long as transparency and other desired benefits can be provided through appropriate means.

MarkitSERV remains committed to delivering operational and infrastructural solutions and enhancing our services to increase transparency, mitigate risk and achieve operational efficiencies. We hope that you will find our comments helpful. Please do not hesitate to contact us if you require any additional information or if you want to discuss.

Kind regards,

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