

## **WMBA/LEBA Reply to CESR's consultation on Standardisation and exchange trading of OTC derivatives**

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Operating as the hub of the global financial market infrastructure, Interdealer Brokers are MiFID compliant and highly regulated intermediaries by virtue of their regulatory authorisation and from being subject to supervision as limited activity firms. Our members are neutral, independent, and multi-lateral and provide free, fair and open access to their trading venues for all suitably authorised and regulated market participants. Interdealer Brokers do not take positions on the platforms they operate and their collective service as the gateway to the global financial marketplace creates price discovery and significant liquidity. All transactions, whether executed via voice, hybrid or fully electronic means, are immediately captured at the point of trade, are subject to straight-through-processing, and are made available for transparent and timely transaction reporting to the relevant regulators.

## **I. Key Summary Points**

### **1. The urgency for clarity on the term 'Organised Trading Venue'**

WMBA/LEBA recognise that while CESR has acknowledged the fundamental utility and dominant role of OTC trading itself, the purpose of the paper is to examine the optimal migration of OTC transactions onto organised trading venues. However, the widespread misuse by CESR of the term 'exchange trading' and, indeed, the additional references in the paper to 'organised trading venue', 'organised venue', 'organised markets', 'organised platforms', 'organised trading platform', 'electronic trading facilities', and 'swap execution facility' create confusion and promote misunderstanding in readers of the CESR paper who will include policymakers. We feel it is highly likely that any reference by CESR to the term 'exchange' will be interpreted by others only in the narrowest, and incorrect, sense. Therefore, as was discussed in the open forum of the **CESR hearing in Paris on 11 August**, WMBA/LEBA urge CESR to take leadership in eliminating misinterpretation by referring throughout the consultation paper and in its formal communication to the European Commission to only 'organised trading venues' which will incorporate multiple regulated means of executing (voice, hybrid voice/electronic and fully electronic), confirming, settling, and reporting derivative transactions.

### **2. No Mandatory On-Exchange Execution**

In connection with the point above, while CESR is not currently contemplating the recommendation to mandate on-exchange trading, WMBA/LEBA feel impelled in the context of the consultation paper to reiterate that we are, alongside the OTC dealer and end investor communities, strongly opposed to any consideration of such an edict. While it is widely held that such a move would drain liquidity, damage otherwise healthy markets, create a number of negative unintended consequences, discourage prudent risk management, create regulatory arbitrage from geographies not adopting such rules, not necessarily increase transparency, has no connection to fully automated post-trade reporting, and increase the likelihood of uncompetitive vertical market infrastructures, the fact that this issue remains subject to debate in some circles obliges WMBA/LEBA to restate the position which we feel offers the highest benefit to regulators and participants.

### **3. Support for Automated Trade Processing**

WMBA/LEBA encourage greater automation of transaction processing generally and have been, are, and will continue to enthusiastically assist the industry's gravitation toward electronic straight-through-processing and the centralised reporting of OTC derivatives. Through the continuing deployment globally of our members' existing automated trade processing systems we support the mandatory usage of automated confirmations generated by our members in each of their hybrid, voice broker assisted, and fully electronic transaction systems.

### **4. Free and Non-discriminatory Access to Clearing Facilities**

WMBA/LEBA unequivocally support the development of central counterparty facilities for the novation and guaranteed performance of OTC transactions including OTC derivatives. Our members have for a generation participated in and, indeed, pioneered, the use of clearing facilities in several other major global OTC marketplaces such as fixed income securities, foreign exchange, options on securities, repurchase transactions and stock lending which have all contributed to the lessening of systemic risk. WMBA/LEBA continue this history by actively promoting the shift of eligible OTC derivative transactions to recognised and fully open central clearing facilities.

However, we are dismayed that some vertical silo-structured central clearing facilities have been allowed to operate in contradiction to the objectives of the European Commission's goals for fair and open marketplaces by obstructing access to API connectivity enjoyed by their vertically integrated execution platforms, and/or barring eligible transactions from external trading venues. A key element in financial market innovation and competition over time is for market participants to have access to multiple execution venues. We therefore urge CESR to make an unambiguous recommendation that all recognised clearing facilities must, by regulation and not merely by design, be neutral and open with completely non-discriminatory access for all organised trading venues in order to promote a robust trading environment.

### **5. Towards Safer and Sounder Markets**

WMBA/LEBA, along with CESR, believe that in order to achieve further market integrity the increased use of trade repositories and, where appropriate, of CCPs, should be encouraged. However, we feel CESR errs by extending the misconceptions associated with references to exchanges by focusing on the regulation of 'products' rather than 'participants' and that by pushing those products into a more constricted environment, tighter regulatory control and sounder and safer markets will inevitably occur. We



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disagree with this approach as the gigantic array of OTC products pending regulation will likely mean that granular product definition on which to base regulation will remain elusive. Clearly, delays in defining products in terms of standardisation, for example, have negatively impacted the legislative process. To achieve the broad aims of the G20 we feel the regulation of participants combined with the comprehensive adoption of trade repositories are the twin pillars of effective regulatory reform.

## Wholesale Market Brokers' Association/London Energy Brokers' Association

The Wholesale Market Brokers' Association (WMBA) and the London Energy Brokers' Association (LEBA) are the European Industry Associations for the wholesale intermediation of Over-the-Counter (OTC) markets in financial, energy, equity, commodity and emissions markets and their traded derivatives. Our members are limited activity firms that act solely as intermediaries in the said wholesale financial markets. As Interdealer brokers (IDBs), our members' principal client base is made up of global banks and primary dealers. The replies below to the questions in the paper should be seen in the context of member firms acting exclusively as intermediaries, and not as own account traders. (Please see [www.wmba.org.uk](http://www.wmba.org.uk) and [www.leba.org.uk](http://www.leba.org.uk) for information about the associations, its members and products.) For this reason some of the questions in the CP are not entirely relevant to member firms' activities even though they are to most of their clients. Further, some answers take into account industry views and experience.

In addition to answering the questions posed by CESR (the Committee) where relevant, this reply also addresses some of the statements made in the Consultation Paper on Standardisation and Exchange Trading of OTC Derivatives (the CP) and sets out the role and functioning of the intermediary in **Annex 1 (structure of OTC markets) and in Annex 2 (the role of the Broker)**.

The solution to current problems in financial markets does not lie in attempting to mandate the transfer of OTC trading onto exchanges. The OTC markets have traded, and need to continue to trade, separate to and in conjunction with exchange markets for many reasons. OTC markets are both larger in scale than exchange markets and a vital risk management tool and as such their use benefits governments, corporations, investors and individuals worldwide. An exchange solution needlessly grants the exchange a monopoly on trade execution (which is usually accompanied by restricted access to clearing) which thereby leads to increased trading costs and risk and diminished flexibility.

The IDB community seeks faster and fully automated affirmation/confirmation of all derivatives trades. This affirmation and confirmation of all OTC trades in all markets needs to be accelerated as close as possible to the trade date. The OTC market has already invested significantly in developing its infrastructure in pre-trade, electronic matching, affirmation and confirmation segments. This infrastructure already contributes hugely to reducing risk and will be continuously enhanced for the benefit of all. The infrastructure developments pioneered by the IDB community will foster quicker settlement cycles in all securities markets. A T+1 settlement cycle for all securities markets should be endorsed.



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The IDBs are at the forefront of the wider adoption of electronic trading. Whilst we strongly advocate that electronic trading has identical price transparency to voice initiated matching, we note the incorrect, wider legislative and public intuition that it is electronic trading only that enables simpler and faster trade capture, despite totally fungible affirmation, confirmation and supervision of trading activity. It is for commercial and technological reasons that we are confident and committed to the adoption of further electronic trading in more OTC markets going forward, and to simultaneously ensure that the post-trade experience of a voice execution mirrors exactly a fully electronic trade.

## II. WMBA/LEBA Input into OTC and Exchange trading

1. OTC markets exist to enable participants to fund, hedge or speculate ("market participants"). The wide array and flexibility of products traded on OTC markets enable market participants to trade in a way that accurately complements their trading strategy. Whereas products traded on an exchange by their nature are standardised as they contain, for example, standard coupons, premiums, expiration dates, OTC products can have terms agreed and negotiated between the counterparties. Accordingly, exchange traded products are unlikely to match a participant's exact requirements and hence carry a differential between the real underlying risk and the defined terms within the exchange contract basis risk.
2. OTC markets have a crucial role to play in all national and international economies alongside and complementary to exchange markets. OTC markets have played a major role in global economic development and have been the provider of solutions that have benefited savers, investors, businesses and governments. There is a very observable bias behind the CESR paper that such OTC markets and especially OTC-derivatives markets hold more systemic risk, are less efficient and less useful than organized or exchange driven markets. This basis is clearly untrue and therefore all replies to the CP need to be tempered in the light of redefining such a basis. Furthermore, referring back to Key Summary Point 1, throughout the paper there exists a general obfuscation between "organised markets" and "exchanges". We reiterate here that the OTC financial and commodity markets that our members facilitate are all highly organised and highly regulated by means of closely supervising and continuously regulating the professional and wholesale participants that constitute these markets.
3. WMBA/LEBA support the G20 objective to ensure "efficient, safe, and sound derivatives markets" and appreciate the recognition in the report that derivatives are important tools for risk mitigation and transfer and that overall they benefit the global economy. We would however ask the Commission to recognise the differences between OTC Products in general and Derivative Products in specific, since whilst they often overlap, they are not fungible. This concept will be expanded upon in our response.
4. We disagree with the European Commission's assertion in 2009 that the "Derivatives Markets" have been at the centre of the financial crisis. We concur with the speech made by Assistant Secretary to the US Treasury Department, Malcolm Barr this August, that Mortgage Lending and Packaging, other Structured Products, Audit Procedures, Credit Ratings and the behaviour of Credit Agencies were all fundamental contributors to the financial crisis. The OTC and Derivatives Markets themselves were the bedrock of the continuing functioning of the financial markets and, indeed, without the ongoing operations of the OTC and

- Derivatives Markets the financial crisis would have been more severe and even more far-reaching.
5. We would respectfully ask the Committee against issuing any recommendations that add further “Incentives” or “Penalties” into the use of derivatives markets. The incentives to promote more transparently transacted products, to adopt automated post-trade processes and to employ central clearing are already strong, clear and present. Any moves towards penalising market participants and end users for not embracing risk mitigation and control processes could lead to the substitution of settlement risk with basis risk (i.e. a mismatch between exposure and protection) and would therefore be inherently detrimental.
  6. Legislation involving mandated “Product Standardisation” would be at best unhelpful. Obfuscation exists between Legal Standardisation, Product Standardisation & Process Standardisation. ISDA has made great progress in legal uniformity and process uniformity in recent years and this trend needs encouragement. An insistence on Product Standardisation in any form would decrease market liquidity, increase gross market risk for all participants and enlarge total net costs for end users.
  7. We would emphasise that the notion of Standardisation has little or no correlation to Clearing. The creation of valid initial margins combined with the daily calculation of correct variation margins is the prerequisite for the operation of a Central Counterparty (“CCP”). Clearly, this process applies to complex or bespoke products as long as reliable margins may be calculated and agreed with clearing firms. However, the responsibility for the introduction of these margin requirements must rest with the Risk Committee and management of a CCP. Indeed, the utility of a CCP can only be determined on a trade-by-trade basis by the behaviour of end-users (i.e. clients of the clearing firm) involved – if there is not a demonstrable net benefit in terms of not just cost but also in front, middle and back office operations and the ability to communicate with customers the CCP offering will not have staying power.
  8. We would stress the requirement for equal and open access, both commercially and technologically, to clearing on a real-time basis for all market participants and note with approval the emphasis regulators around the world have recently placed upon the unbundling of Execution and Clearing.
  9. We remain concerned that the Committee is paying insufficient regard to the mechanics of Price Formation in Derivative Markets by the implicit unfavourable comparison of voice brokered price matching against continuously quoted, electronically matched markets. Publicly available data confirms that purely exchange traded products experienced a notable decrease in volume in “Benchmark” or “Plain Vanilla” products during the recent extreme market volatility as the price discovery and counterparty protection provided by voice brokers became more crucial in keeping the markets functioning. This volume transfer from exchange traded, fully electronic volumes to the voice sphere was one of the most meaningful events of the financial crisis and, while temporary,



- will have a lasting impact on the structure and behaviour of the OTC and Derivative marketplaces. Efficient risk transfer and the automation of the post-trade confirmation, affirmation and clearing remain critical, and recent experience has confirmed that these facilities are independent of the means of execution, i.e. that voice, voice assisted or fully electronic IDB OTC transactions follow the identical post-trade path as do exchange traded products. We stress that whichever way prices are formed, the post-trade automation and transparency remains uniform. Paramount here is the market demand for flexible voice brokerage in periods of crisis and market stress has never been higher and therefore the IDB community wishes to call attention to our role in mitigating risk and our commitment to continue to participate with authorities to implement practical solutions for our mutual constituents.
10. The perception of OTC markets as “unregulated” overlooks that fact that all major market participants are individually regulated and codes of conduct are set by supervisors in most OTC markets. WMBA/LEBA endorses not only MiFID, but also the Bank of England’s Non-Investment Products (“NIPs”) Code and Market Abuse Directives. Competition is embedded into MiFID, ensuring end user efficacy. We repeatedly emphasise the wholesale nature of the OTC markets, especially OTC derivatives and the tightly regulated status of all the market participants involved. Any CESR proposals therefore would need to be focused on the parties to a trade rather than the product involved and to recognise the need to explicitly differentiate the intended impact of any proposed legislation on the separate wholesale and retail participant communities.
  11. We do not recognise the OTC, or Derivatives Markets, as opaque. Rather the sheer scope, breadth and depth of the transactions frequently do not lend themselves to the type of “Benchmark Reports” that are quoted from futures markets.
  12. Data is reported in a timely way to quote vendors at a maximum delay of sixty minutes and, as highly regulated entities, IDBs report trades to regulators. Furthermore the WMBA/LEBA remains in a position to provide regulatory authorities with aggregated price and volume transactions across all OTC and Derivative markets at a close of day periodicity. Notwithstanding full regulatory disclosures that currently exist, we reiterate the need for certain transactions to have either no or bespoke pre-trade transparency requirements as a prerequisite for sufficient liquidity.
  13. In their pursuit for greater transparency, we reiterate that the regulators distinguish between the interdealer and the dealer to client segments of the market in order to formulate the best regulatory framework. This should enhance the recognition of the role of the liquidity providers and differing mechanisms of price formations in the optimal functioning of the different segments of the markets e.g. wholesale and retail marketplaces.
  14. IDBs, as a dimension of the flexibility inherent in their voice and electronic brokerage venues, do now universally employ the straight through processing

- tools required to link customers with clearing houses, settlement systems, securities depositories and a client's own middle and back office platforms. This facility is the foundation for both current solutions and new product development. The IDB community advocates greater use of pre-booking netting. In many cases, transactions can legally and economically be netted, rather than settled on a gross basis, providing the corresponding benefits of lighter middle and back office flows and more optimal use of capital as gross positions need not be financed.
15. Mandating the entire wholesale OTC derivatives markets onto exchanges or regulated electronic trading systems that do not encompass the entire product offerings of IDBs fails to recognise not only the substantial investments that both the IDBs and dealers have already made to improve market infrastructure but also will discourage the industry from making such investments in the future.
  16. WMBA/LEBA are keen to highlight that even in the equity markets, substantial traded volumes are executed OTC because of their size and overall sensitivity and then posted on the relevant exchanges. Similar to an exchange being able to operate, under its status as both an outcry and electronic marketplace, we recommend that any possible change in status that would aim at encouraging the execution of the trades in the OTC markets in a similar environment to that of exchanges not be limited to solely electronic means of execution and should encompass all the voice, hybrid and electronic marketplaces operated by the IDBs.
  17. An overhaul of some areas of the regulatory framework supporting wholesale financial markets is now deemed necessary by both national supervisors, such as the FSA, through the Basel II process, and the CRD. But serious - and perhaps unintended and unfortunate - consequences may well follow if a short-sighted diagnosis of the problem is reached and/or heavy-handed actions are taken in response to the current market turmoil. The impact of these consequences would fall on many retail end users outside wholesale OTC markets, including governments, corporate and retail borrowers and investors.
  18. WMBA/LEBA believe that the CCPs are not in and of themselves a universal panacea and need to operate in close cooperation with central banks in order to meet the objective of reducing any systemic risk. The shareholding and governance structures of CCPs should be reviewed with great care as the mere existence of the CCP is no guarantee of reaching the desired objectives. Further we believe that Trade Repositories can help to alleviate many of the concerns that regulatory authorities may have and have falsely looked to both CCPs and exchanges to remedy. Many OTC markets may benefit from the wider utilisation of CCP operations. However, the decisions to use such entities should not be mandated but left to the discretion of the end user in order not to increase trading costs, increase hedging and further basis risk, constrain end user cash-flows, compromise end user accounting standards & conventions and diminish market flexibility.

19. WMBA/LEBA look forward to working with EU policy makers, legislators and regulators in developing the proper regulatory framework and standards in order to continue to serve our mutual customers in healthy European and global financial markets for decades to come while at the same time meeting the regulators' concerns without any detrimental effect on liquidity.

### III. Answers to Consultation

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?*

Whilst question one also intimates an implicit mapping of "Standardised Trades" to "Electronic Platforms", a more useful linkage is found by associating "Cleared Trades" with "Electronic Platforms". This is because IDB electronic platforms are fully able to transmit transaction details to any clearing infrastructure whether the trade details are "standardised" or not. Again, the key for clearing is not whether a product is "standardised" but rather if the product displays continuously and transparently available prices sufficient to calculate and maintain margin requirements at the relevant clearing house.

The CESR assessment on standardisation of OTC derivatives does not adequately take into account the full scope of transaction elements such as these listed below:

- Gamma
- Vega
- Delta
- Rho
- Spread to Theoretical
- DVO1 per bucket
- Spread to Cash

Therefore, any consideration of standardisation using CESR's current metrics will by definition exclude a large proportion of OTC derivative transactions. The highly bespoke nature of the derivatives markets, therefore, demand that in order for regulatory reform to be effective, CESR's focus should be on post-trade events rather than a strict definition of standardisation.

Whilst we agree with CESR that the use of electronic confirmation systems do indeed deliver benefits to the market, we would correct the committee to firstly emphasise that such post-trade architecture is widely in place and in operation; and secondly to note that further homogenisation of the products merely for the sake of arriving at a

definition of standardisation would be detrimental to market efficiency and risk mitigation in general.

Therefore regulators should neither focus upon elements of standardisation nor any particular asset class. Suitable capital and cost incentives will allow the market to continue to deliver efficient solutions. The WMBA/LEBA would highlight the work of ISDA over recent years in this respect.

**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?**

The reasons why "electronic means" may not be tools for standardisation revolve around the needs and requests of clients and end users. These customers may want a dialogue with the brokers, the ability to deal in innovative products, to enter into a bespoke contract, or to use a voice service in parallel with screens as a means to execute a trade. Across the full spectrum of clients we witness a range of different needs. Therefore, restricting the designation of "standardisation" to fully electronic events ignores the reality of the inner workings of the marketplace and would be a disservice to the end user community. For instance, as clients dealing in "Structured Products" may need to fragment or aggregate trades and implement complex bespoke trading to suitably execute on some markets and hedge their risk profile, allowing the voice component to contribute to the consideration whether a product should be designated as "standardised" (or not) recognises the practical operations of the marketplace.

Following on from the above point, it may be intuitive that the level of process automation may well decrease as a function of product complexity. However, the rapid pace of innovation in the IDB brokerage community means that as products do become more complex, the post-trade automated systems supporting these products expands to capture more elaborate trade details as time goes on. Normally the tools necessary to embrace more complex products are add-ons to existing infrastructure and many enhancements can be made in real time. Therefore, as process automation is continually and dynamically evolving, the definition of standardisation cannot be defined by a static assessment of process automation: by the time a given process automation cycle is analysed, an updated version may already be in place.

In truth then, "standardisation" is more synonymous with "eligibility for clearing". However, from the perspective of the counterparty or from the actual transaction, there are many other indicators that may measure the degree of Standardisation of a contract. WMBA/LEBA believes that the characteristics of standard products are manifold and need to be carefully considered.

As soon as the legal documentation is in place such as ISDA or GMRA; markets have a solid basis to develop different ways of putting products together. Transactions may be

matched via either voice or electronic means. There is a widespread misperception that non electronic matching is not cleared. In fact, most of the products in today's markets are cleared but it is the methodologies behind price formation which differs.

Historically, highly liquid, commoditised and simplified products have been the most suitable for inclusion in electronic trading systems. However, the equally important confirmation, affirmation, clearing and settlement functions are significantly simpler to develop and implement. For all voice, hybrid or electronic trades, an electronic ticket is created post-trade and registered, resulting in the identical treatment of voice and hybrid trades as to those executed fully electronically from a post-trade perspective. The choice of clearing venue and/or use of CCP facilities then depends upon the client's wishes and requirements, the CCP choices available (*see annex 3*) – and not whether the product fits some definition of "standardisation". Indeed, incentives for smooth post-trade processing already exist as non-regulatory measures such as sound cost management and peer pressure continue to exert influence to make the markets more efficient while bringing costs down as much as possible. The key point here is that commercial pressure to identify and deploy the most cost effective transactional, clearing and settlement procedures possible will drive business decisions and will override considerations based on narrow definitions of "Standardisation".

Whilst the prescription of capital charges can be used as an incentive to raise transactions into clearing, it should be noted that risk still resides in a CCP. We note that Pillar I of the Basle Accord already accounts for credit risk and market risk, so when looking at whether to apply capital penalties to non-cleared contracts, the issue at debate here is whether to "punish" end users for entering into bespoke and specific hedging of their business risk. The cost of capital charges versus the cost of basis risk should not be an option that the Commission would wish to prescribe to either corporate or any other financial entities looking to hedge financial risks. As an objective of policy it would appear contradictory, at a minimum, to punish such macro-prudential risk management as entering into precise hedging strategies as being undesirable.

**Q3:**

**Do you agree that greater standardisation is desirable?**

**What should be the goal of standardisation?**

Greater standardisation is desirable in the areas of the post-trade processing of OTC derivatives and the legal terms underpinning and defining the contracts traded.

Given the overwhelming and undeniable preference exercised by participants and end users in these markets to hedge bespoke risks and minimise basis risks, there can be little doubt that outside the popular political mandates, there is no appetite for enforced product standardisation. Recent evidence would imply that natural product evolution, commercial pressures, and industry collaboration will result in further standardization in the future.

Additional witness to this may be found in the fact that the WMBA/LEBA understand that about 96% of all listed futures contracts report no traded volume whatsoever as they do not offer either the desirable bespoke characteristics nor the competitive dealing costs found in the OTC markets.

**Q4:**

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

Further working groups and regular contact between participants and supervisors along the lines of recent work spearheaded by ISDA and aided by other industry associations including both WMBA in Europe and WMBA in Washington will prove beneficial.

**Q5:**

**Are there any obstacles to standardisation that could be removed by regulatory action?**

**Please elaborate.**

Liberalising and opening the European legal landscape across all the European 27 nations would aid in defining common terms and obligations across all OTC market participants.

Regulators should also ensure free and fair access to CCPs for all organised trading venues. We would note that this free access is effectively blocked by the current bundled pricing mechanisms and closed access to requisite trade entry automated software by the vertically integrated trade execution and clearing platforms.

Derivatives trading strategies frequently use equity indices to secure cost effective and transparent economic exposure to equity markets, as well as being widely used for hedging purposes. Certain indices are owned and/or traded only on a particular exchange. Therefore, an obstacle to be noted is intellectual property licensing which may unintentionally grant an underserved monopoly to the provider of an underlying component of these strategies. Clearly, then, intellectual property licensing may restrict competition in derivatives trading and clearing. WMBA/LEBA is concerned that index owners may either restrict trading of their index to certain execution venues and may restrict the delivery of associated products into certain CCPs by making licensing arrangements so cost prohibitive that alternative venues will not be able to trade and/or clear the product. Accordingly, indices should be subject to non-exclusive and non-discriminatory licensing arrangements to enhance liquidity

**Q6:**

**Should regulators prioritise focus on:**

**a) certain element of standardisation**

**and/or b) a certain asset class?**

**Please provide supporting rationale.**

Greater standardisation is desirable in the areas of the post-trade processing of OTC derivatives and the legal terms underpinning and defining the contracts traded. Therefore standardisation on the arena of trade matching should not be a priority for regulators.

It should also be noted that all product areas demand specific attention to the idiosyncrasies of their markets. A one-size-fits-all approach will be detrimental to market efficiency.

**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.**

The use of electronic confirmation, affirmation and payment systems is already widespread in each and every aspect of OTC derivatives trading by our member firms and their clients. Indeed, significant investments have already been made and will be made in the future in the normal course of business operations by our members irrespective of regulatory edicts as these features make sound commercial sense and the smooth electronic post-trade functioning of the OTC derivatives marketplace is not reliant on any particular regulatory decision. Other than the costs associated with this continued natural investment in product development, additional costs at this point are unquantifiable. In any event, the IDB community expects to make further investments to support post-trade transparency and reporting as this makes sound commercial sense for us and our customers. However, the cost implications of unintended consequences of mandatory regulation in this area could be significant for all market participants.



## EXCHANGE TRADING

*One of the key regulatory initiatives which have emerged as a result of the events of the financial crisis is to make OTC derivative markets more resilient by reducing the bilateral nature of transactions and to provide market participants with better access to more transparent markets.*

WMBA/LEBA would once more reiterate that the OTC derivatives markets were neither causal nor complicit in the causes of the financial crisis; therefore the context of the CESR reasoning in this section is flawed. We would point to the speech made by Assistant Secretary to the US Treasury Department, Malcolm Barr this August, that Mortgage Lending and Packaging, other Structured Products, Audit Procedures, Credit Ratings and the behaviour of Credit Agencies were all fundamental contributors to the financial crisis.

The OTC and Derivatives Markets themselves were the bedrock of the continuing functioning of the financial markets and, indeed, without the ongoing operations of the OTC and Derivatives Markets the financial crisis would have been more severe and even more far-reaching. Furthermore the remedies applied by the authorities to alleviate the crisis: increasing the quantity of money to the banking system, lowering the cost of money and cheapening the terms of trade, all required the use and good functioning of the said OTC and derivatives markets.

We would further look to correct some of the misconceptions of the Committee by underlining that OTC trades gain liquidity by not being bilateral; i.e. one seller v many buyers allows the efficient mining of liquidity.

Additionally all trades on any platform are bilateral at the point of matching. Therefore the divisions cited here by the Committee would appear illusory.

Wholesale professional markets are very different to the retail equity type markets with which the Committee may be more familiar. Due to the large deal size and lower relative levels of latent liquidity populating any particular contract, the Committee also misunderstands that it is most frequently the case in these markets that increasing the demanded degree of transparency compromises the risk positions of participants and produces less liquid and more inefficient markets. We would also draw attention to the frequently cited case of the imposition of TRACE in the US to the corporate bond market, which coerced the professional participants and almost all liquidity into the CDS equivalent market.

Further, we would highlight the "Flash Crash" of May this year to illustrate why exchanges are not a panacea and to underline the fact that on-exchange traded products do not inherently provide continuous liquidity.

*At present, the OTC segment in derivatives trading is estimated to account for over 85% of the market if measured in notional amount outstanding. However, any comparison of exchange trading with OTC trading in notional amount outstanding needs to take into account basic differences arising between exchange and OTC trading. The OTC trading data capture gross positions whereas the exchange data represent net positions.*

*The market share of on-exchange trading in different asset classes is indicated in the table below. Because of the difference between gross and net position, the table should be read only as an indication of the scale of the differences between various assets, not as an absolute measure of on-exchange trading. Indeed the absolute level of on-exchange trading is higher than indicated. Credit derivatives are not included, because of the negligible amount of exchange trading.*

The Committee seeks to mitigate the relative size and importance of the OTC and their derivative markets in the above phrasing by reconstituting the nominal data into traded volume data. WMBA/LEBA would note that the OTC market is, in reality, significantly larger and, by extension, more fundamental and more efficient than the exchange traded markets. Indeed, the OTC market dwarfs on-exchange trading as, according to the BIS in December 2008, roughly 90% of global volumes outstanding across all product sets was traded OTC. Further, heavy intra-day trading by high frequency firms exaggerates the relative on-exchange volumes which are of far less importance than the Committee may believe.

In terms of the order of magnitude, when volumes peaked in 2007, again according to the BIS, gross notional amounts of on-exchange derivatives amounted to nearly USD 80 trillion. By contrast, at the same time notional amounts of outstanding OTC derivatives amounted to USD 605 trillion.

Whilst we note the symbiotic relationship of exchange contracts and the wholesale OTC markets, we would repeat that the latter are over 10 times the size of the former. Therefore attempts to force these volumes onto exchanges would be nonsensical, systemically risky, and against the laws of common sense. Furthermore, it is important for the Committee to appreciate that much on-exchange volume is derived from the hedging of OTC transactions. Without the large OTC markets trading in the manner and size that occurs today, on-exchange volumes would dwindle and the liquidity and latency upon which they rely would diminish. It is against this context that the CESR recommendations to migrate OTC towards exchanges would appear illogical.

*The G20 and the European Commission have stated that all standardised derivatives should be traded on-exchanges or electronic trading platforms, "where appropriate". In this context it is necessary to identify the potential benefits and limitations of exchange trading of derivatives as a preliminary step.*

*These benefits and limitations may differ depending on the type of instruments and investors concerned. Exchange trading and OTC trading are often viewed as being complementary and serving different needs, hence offering various kinds of benefits to different stakeholders*

The Committee references advantages offered by on-exchange trading of price transparency, risk mitigation and transaction costs. We would correct these comments in noting that there are few long resting wholesale interests visible on-exchanges, that is, that almost all interests are disguised and withheld, leading to far less transparency than may be professionally gained from the OTC markets. We note that in the exchange traded equity markets, this has resulted in the creation and proliferation of Dark Pools to facilitate the requirements of wholesale level trades.

The potential for efficient and suitable hedging and risk mitigation is plainly and clearly evidenced daily in the OTC and derivatives markets; whilst the costs and ability to access the OTC and derivatives markets in the manner and time of the participant's choosing are substantially lower and more equitable.

## Transparency

**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?**

WMBA/LEBA strongly disagrees with the CESR assessment of the benefits and limitations of the exchange trading of OTC derivatives. The OTC framework, both cleared and bilateral offer vastly higher capabilities to mitigate risks quickly, efficiently, cheaply and liquidly compared to the limited access fixed contract exchange environment. The ease of access, equitable nature, competitive environment and minimal cost of doing business all enhance the OTC framework.

It should be emphasised that the OTC framework allows a more bespoke social utility to the hedging of risk, whilst its professional, global and wholesale market nature contrasts to the often retail and regional characteristics of the exchange environment where access is closed to all but members.

With respect to transparency, it should be noted that the views of CESR are questionable as efficient price discovery may not occur in an on-exchange framework as such markets open only at certain predefined times and are available only to certain users who are members of the venue. The fully open OTC framework, by contrast, is quite the converse

and IDBs operate in this market to assist the development of market liquidity across time-zones and to support and to link a wide range of market participants.

An IDB's role in facilitating the flow of information between dealers is a critical service which both enhances liquidity and results in improved prices for market participants. Pre-trade, IDBs facilitate market information flow in a number of ways. IDBs post end-of-day or other fixing pages and disseminate intraday market information through their own electronic systems or that of market data providers such as Reuters and Bloomberg to their dealer clients. By providing anonymity to their dealer clients, IDBs thereby encourage dealers to supply the IDB with market information, and so the IDB is likely to have a more complete composite picture of the market than any one dealer or combination of dealers. Finally, by aggregating this information in conjunction with price quotations, IDBs provide participants with valuable information that reflects the real-time state of the market not simply the best price, as is the extent of the information available on exchanges. IDBs also facilitate post-execution price transparency through publication of trades on screen at time of trade and via commercial data services available from the IDB Data Sales businesses. As a result, market confidence levels increase and more market participants are attracted to trade.

**Q9:**

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

Again, we query the misuse of the term "exchange trading" by the Committee. The IDB sector is committed to offering execution choices for clients so that they may engage in fully electronic transactions in a variety of OTC derivative products should they wish to do so. Every sector of the OTC marketplace is ripe for migration to electronic trading (to the extent that the source of pre-trade price and notional volume disclosure is not compromised) and as an industry the IDBs have collectively been extremely pro-active over the last decade to lead the markets in this direction and are now continuing to make substantial investments into trading systems to support wider electronic trading of OTC instruments in the future.

**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.**

IDBs play a significant role in providing direct market interface for the participating dealers or principals and therefore, liquidity in the market. Market participants should be encouraged to use IDBs.

As previously described, it is not the case that the type of transparency associated with “exchange trading” will necessarily increase regulators understanding and ability to discern potential risk in the system. More frequently the opposite may be the case. Often the lack of direct participation by the underlying participants, since all orders need to be routed through an exchange member and given up to an exchange clearing member, means that the direction, size and strength of the underlying economic interests are easily withheld and disguised as a matter of course in the exchange world.

To the extent the Committee is drafting this question using the term exchange trading in the widest sense, WMBA/LEBA feel that as long as the underlying mechanics of OTC trade negotiation and execution are left intact, all sectors of the OTC derivative marketplace could benefit from the increased transparency associated with trade repository reporting, electronic affirmations and confirmations, and additional supervisory oversight as long as “transparency” does not mean the public pre-trade publication of prices and notional amounts. Clearly, implementing legislation that mandates all trades to be pre-trade transparent or traded on an exchange could have the dramatic effect in less liquid, thin or volatile markets of further reducing liquidity, widening spreads, and thereby actually increasing systemic risk by virtue of detrimentally affecting the ability of market participants to value and exit positions without incurring significant loss.

**Q11:**

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

The wishes of market participants for efficient and utile markets are the paramount drivers of evolution. Currently nearly all OTC markets, both derivatives and cash products are traded on “organised platforms”, many of which are operated by the members of WMBA/LEBA. Therefore we question the premise of the Committee’s question, as organised platforms are already in operation to support a wide variety of OTC derivatives.

The main factor which could discourage a greater percentage of OTC derivative volumes from being executed on organised platforms is unwise reform mandating the migration of volumes to an on-exchange environment which could drive dealer and end user business to other geographies or jurisdictions.

Essentially, the liquidity in the market may in of itself dictate whether or not a product merits being adopted on an organised platform as it is likely that low velocity products will remain voice executed purely on a cost-benefit analysis for platform providers. (Even so, voice executed transactions may still be introduced for electronic post-trade treatment.)

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

WMBA/LEBA are of the opinion that the issue here should not involve a process of setting unrealistic thresholds which would be explicitly aimed at coercing markets into modes that may not be those best suited to the most efficient and beneficial market functioning.

Therefore there is no particular level of liquidity that would be relevant, and if there were the migration to an exchange could diminish liquidity and even induce the cessation of trading and migration back to OTC. Further, there is an obvious problem associated with setting targets as volume in a particular product may periodically dip below an agreed limit which would cause disruption of market operations. We would query why the Committee would find any of these cases a desirable outcome.

*Assessment of characteristics/level of standardisation that OTC derivatives have to meet to be considered eligible for trading on an organised trading platform*

*A broad universe of exchange-traded derivatives currently exists with over 1,700 different derivatives listed on the three major global derivatives exchanges (Chicago Mercantile Exchange, Eurex and Euronext.Liffe). As noted above there are also a number of MTFs trading platforms and single dealer electronic trading platforms which are used to transact derivative contracts?*

*In CESR's view the cornerstone for eligibility for trading on an organised trading platform is a high degree of the three elements of standardisation as outlined in section in 2.1. Namely:*

- 1. Legal standardisation;*
- 2. Process standardisation; and*
- 3. Product standardisation.*

WMBA/LEBA note that in order to promote electronic trading, one only needs the first two of these three criteria to be met. Very often, the underlying risk factors are being traded in a derivative, and therefore the derivative itself is not a standard product, and there is no reason why it should need to be. Rather than product standardisation, WMBA/LEBA urge CESR to instead focus on the post-trade confirmation, repository and supervisory aspects to deliver the clarity in participant positions which is at the core of all regulatory reform.

## Additional factors to consider

*A high degree of standardisation of these elements is important, this may not be sufficient to successfully support trading on organised trading platforms*

WMBA/LEBA would query why the Committee appears to have concluded that any particular venue of trading is more beneficial than any other and therefore why the venue of execution has any bearing on the Committee's recommendations as long as immediate post-trade transparency is delivered. In reality, participants should be able to choose from a spectrum of offerings where they are best able to hedge risks and execute business as long as these trades are made visible to regulatory and supervisory bodies.

1. *The size of the underlying market*

2. *The size and diversity of market participants*

3. *Liquidity*

4. *Availability of CCP clearing*

1. *Contract fungibility*

*Exchange traded contracts are typically fungible i.e. one contract fully substitutes the other. This allows for contracts to be netted and allows market participants to more effectively close open positions.*

In the context of this paper addressing the OTC derivatives markets, it must still be noted by WMBA/LEBA that many markets such as the fully OTC FX and Government Bond markets fulfil the above criteria entirely - a large underlying market, a wide diversity of market participants, constant and reliably high liquidity, plus access to central counterparty post-trade services – and have steadfastly remained OTC.

Therefore, the various metrics posted above are not determinates of why a product is executed in an OTC or in an exchange environment. The key here is that many of the attributes that the Committee seems to apply to organised trading platforms already exist, and have existed for a generation, in the OTC marketplace. So, the question for the Committee in making recommendations to the Commission, and by extension to G20, should focus not on the product characteristics, but rather on ensuring that the post-trade transparency telegraphs all features of market participant's net market exposure to the relevant authorities.

CESR is keen to better understand what additional factors need to be in place, and what regulators can do to achieve greater trading of derivative contracts on organised trading platforms. Specifically CESR wishes to consider whether the availability of CCP clearing and contract fungibility are essential determining factors for a contract to be traded on an organised trading platform.

WMBA/LEBA would again remind the Committee that almost all our products are currently and participants are able to transact over the organised trading platforms operated and offered by the IDBs.

WMBA/LEBA would also note that many platforms provided by our members operate with either, or with both, a cleared and/or a bilaterally settled environment. Central clearing suits many products, but equally does not suit many others where settlement is close to trade date and credit exposure is limited or a thinly traded product where infrequent execution renders an observable daily closing price elusive. As many of the products currently traded on IDB organised trading platforms are not centrally cleared, this cannot be a prime determinant. Fungibility is also not essential as to whether a product is available on an organised trading platform, as we know that the world's most heavily traded financial futures contracts can be cleared in only one location. Among the more important factors are liquidity, depth and breadth of market participants, infrastructure underlying the product, transaction velocity, whether the product is wholesale or retail, and notional amount outstanding.

**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?**

While legal and process standardisation are essential, WMBA/LEBA reiterate that product standardisation is not only irrelevant, but, indeed, the focus on this area may be extremely detrimental in achieving the Commission's goals on schedule. This is highlighted by the fact that many current OTC products which may be deemed to be "un-standardised" are heavily traded over the IDB's existing organised trading platforms.

**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.**

Absolutely not. Not only is this proposition inaccurate as the bulk of products currently executed on organised trading platforms are not centrally cleared but, worse, by making



clearing a pre-determinate factor regulators run the risk of negatively impacting the scope and breadth of the functionality of organised trading platforms as the spectrum of conceivable products is reduced by the necessity of having to be submitted to a CCP. This has been supported by operators of CCPs themselves who are hesitant to have excessive obligations on the clearing of derivatives enforced upon them.

For the avoidance of doubt, the IDBs as an industry have long championed the role of central clearing in the OTC markets and are unanimous in their belief that CCPs can play an active role in increasing liquidity, transparency and effective risk management across a wide range of products. To reiterate an earlier stated position, however, we do not believe that central clearing should be mandated. We agree that CCPs need to be able to decide themselves (or rather the "Risk Committees" made up of clearing members which sits above the management) which products they deem to be able to clear.

N.B. As an additional observation, WMBA/LEBA would submit to the Committee that our own views on how to determine whether a product could be successfully centrally cleared should be based on whether it fulfils most, if not all, of the below criteria:

- Must be denominated in a globally acceptable currency
- Must be recognised by a regulator or by regulated trade body, and they must have documentation that is ratified by a regulated body
- Must have a defined term or tenor and identical characteristics whether traded by a dealer or an investor
- Must not require any title transfer nor be referenced to a specific titled security.
- Must be traded alone and outright and simply modelled in its payoff profile
- Any annuity of payments must be able to be efficiently transferable and reconcilable by a CCP
- Any triggering or discontinuity of payments must be able to be managed by a CCP
- Must have a 'straightforward' and replicable settlement & expiration process.
- Must be priced on a daily basis and must meet some minimum volume requirement.
- In the context of clearing; it must be commercially viable.

**Q15:**

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

**If so, which factors would be necessary to achieve full fungibility, not only within the same market but across different execution venues?**

**Please provide supporting rationale.**

No. Fungibility is only relevant to those contracts that are cleared. We note again that the majority of OTC trades conducted over the organised trading platforms operated by our members have historically not been cleared.

**Q16:**

**Which derivative contracts which are currently traded OTC could be traded on an organised trading platform?**

**Please provide supporting rationale.**

All trades that our members intermediate are traded over organised platforms by virtue of the fully regulated status of all IDBs operating under MiFID. These facilities function across a continuous spectrum from voice through hybrid screens to fully automated execution. Theoretically all trades could be facilitated on fully automated electronic venues if this was preferred by market participants to the extent, again, that pre-trade price and notional amount disclosure is not compromised. The voice and hybrid business models currently operated by WMBA/LEBA member firms has evolved to date to best serve the demands of our clients with respect to the liquidity and characteristics of the OTC products being traded and do not preclude a more full migration to fully electronic capability.

Incidentally, WMBA/LEBA believes that the evolution of trade flows onto transparent and efficient trading platforms was well underway long before the credit crisis and indeed long before MiFID. We would point to the long evolution of FX platforms resulting in Reuters Dealing, Reuters Matching and EBS, to the eSpeed trading platform which offered fully electronic US Treasury trading as early as 1998, to BrokerTec and to Trayport in an array of energy products as just a very few examples. We would also highlight the role that CLS plays in the post-trade environment in the currency markets and the one that EFET.net fulfils in the energy markets to illustrate how transparent and seamless confirmation, affirmation, aggregation and netting has been developed continuously inside the OTC markets away from regulatory mandates. Additionally it should be noted that the OTC "CDS Index Market," and a good percentage of the "Single Name CDS Market" was being traded electronically well before the crisis of September 2008.

The key objective here, as throughout our reply to this consultation, is to offer the end user choice, efficacy and transparency. It is in the interests of all participants in the OTC markets to promote these ends and it was the provision of such measures that allowed the OTC markets to continue to operate throughout the credit crisis empowering corporate, financial firms and governments alike to raise funds and to offload, assume, or manage risk as they best saw fit during those turbulent times.

**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.**

Under the assumption that the term “organised trading platform” includes voice, hybrid or fully electronic executed transactions, as we have done throughout the CP, all OTC derivative products are eligible for being executed on an organised trading platform such as those operated by our member firms.

**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.**

*86. Therefore, the defining aspects of exchange trading that provide added value to central clearing according to the Commission Communication are: • a multilateral trading system (to eliminate the bilateral nature of concluding trades); • pre- and post-trade transparency (to provide high visibility to prices, volumes and open interests); • easy market access.*

*87. Some characteristics of “organised trading functionalities” according to MiFID that may further clarify these criteria from the Commission for trading on organised trading venues, are nondiscretionary and transparent rules, objective criteria for the efficient execution of orders, non-discriminatory access, authorisation/regulation and monitoring by competent authorities, operational resilience and surveillance of compliance with the organised trading venue’s rules.*

With respect, the question itself is misleading as paragraph 86 references general characteristics of exchanges (although not all “exchange” trading is cleared) and paragraph 87 references MiFID requirements for a MTF. If MiFID is being amended, the Commission need to consider widening the scope of the MTF definition to encompass a greater flexibility to execute trades. Post-trade requirements should be covered in EMIR.

CESR should be aware that all trading facilities operated by the IDBs allow fair, free and non-discriminatory access as well as execute orders fairly and efficiently according to the Bank of England NIPS code of conduct and FSA authorisation requirements. Both our

members as operators and participants are fully regulated and transactions are reported to the local competent authority as required.

In particular, WMBA/LEBA would further draw the attention of the CESR Committee to the work being done in the United States by the CFTC together with the Wholesale Markets Brokers' Association Americas (WMBAA) to detail the full prudential and compliant operation of the SEF platforms with regards to the OTC derivative markets and the US Financial Reform legislation. We would also direct CESR to our answer to question 23 and believe that in any amendment to organised venue in MiFID, the Commission should ensure that it is not significantly narrower in scope than a SEF.

**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.**

Yes. All the organised and fully regulated platforms operated by our members, including but not exclusively those currently covered in the narrow definition of a MTF, have the ability to make pricing information (both pre- and post-trade) available on a multilateral basis. This is in accordance with the recent FSA CP on MTF functionality and compliance.

In addition to the proprietary broker pricing screens of the WMBA/LEBA members, these facilities also include such facilities as those listed in Annex 5.

### **Regulated markets and MTFs:**

*According to MiFID, they "represent the same organised trading functionality". They also provide pre-trade transparency on current bid and offer prices and the depth of trading interests at these prices and post-trade information on the executed trades.*

*Operators of RMs and MTFs have to establish organisational arrangements, including monitoring the compliance with the market rules, in order to ensure the sound and efficient functioning of the market and to fulfil pre-and post-trade transparency obligations.*

*Access to trading on these markets is possible for all participants who meet the requirements set in the market rules. Apart from other requirements, regulated markets and MTFs are requested to establish and maintain transparent and non-discriminatory rules, based on objective criteria, governing access to their facility or membership of the RM. In contrast to requirements for RMs and MTFs, SI obligations are focused on the equity market and specifically on retail clients. Unlike the cash equity markets, OTC derivative markets are essentially wholesale markets.*

**Q20:**

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

Systematic internalisers (SI) are not relevant to the organised and fully regulated MTF platforms operated by our members.

**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?**

Systematic internalisers should not be applicable to the wholesale markets whose participants are either Eligible or Professional counterparties trading on the organised and fully regulated MTF platforms operated by our members.

## **Crossing systems**

**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”?**

Crossing systems are not relevant to the organised and fully regulated MTF platforms operated by our members.

## **Other electronic trading facilities: the US case (“swap execution facilities”):**

*In the context of current regulatory initiatives in the field of derivatives markets, alternative trading facilities are in some jurisdictions envisaged as an equivalent to on-exchange trading when they meet certain criteria.*

*102. For example, the US regulators consider that standard OTC derivatives should be traded on-exchanges or ‘swap execution facilities’. In the regulation currently under discussion in the legislative bodies of the United States and recently approved by the Senate<sup>39</sup>, a swap execution facility is defined as “facility trading system or platform in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by other participants that are open to multiple participants in the facility or system, through any means of interstate commerce, including any trading facility, that—*

*(A) facilitates the execution of security based swaps between persons; and*

*(B) is not a designated contract market.”*

*103. It is proposed that standardised swap transactions will have to be executed on a swap execution facility if not executed on-exchange.*

*104. The ‘swap execution facilities’ as considered in the US present in particular the following characteristics:*

*- ensure real time post-trade transparency (as soon as technologically practicable after the time at which the swap transaction has been executed);*

*- promote the protection of markets and market participants from abusive practices committed by any party, and equitable trading;*

*legally match or confirm trades; and*

*have self-regulatory functions to police for fraud, manipulation and other abuses in the marketplace*

*105. In addition, the draft legislation envisages a general requirement to provide participants with impartial access to the market.*

*106. Consideration of the legislative approach adopted in the US is relevant in the context of meeting the G20 commitment and specifically whether the EU and US legislative frameworks differ. In Europe the current legislative framework would appear to support a narrower definition of trading on an exchange or electronic trading platforms.*

*107. OTC derivative markets are clearly global therefore CESR needs to assess whether the approach adopted in the EU and the US in meeting the G20 commitment offers scope for regulatory arbitrage.*

**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?**

Yes. The US definition of a SEF is very similar to the MiFID definition of a MTF – both are systems that bring buyers and seller together for the execution of trades on a multi-

lateral basis. In fact the core principles being discussed with the CFTC are not significantly different from those adopted by the FSA in its Handbook (MAR 5).

However, a SEF specifically references that trades can be executed by “any means of interstate commerce”. This enables, prima facie, voice trading, although there are a number of other provisions set out in the US legislation that will require post-trade automation from the point of execution of a trade. A SEF is defined as follows:

“SWAP EXECUTION FACILITY.-The term 'swap execution facility' means a trading system or platform in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants in the facility or system, through any means of interstate commerce, including any trading facility, that-

- (A) facilitates the execution of swaps between persons; and
- (B) is not a designated contract market.”

The definition of a MTF under MiFID is “a multilateral system, operated by an investment firm or a market operator, which brings together multiple third-party buying and selling interests in financial instruments - in the system and in accordance with non-discretionary rules - in a way that results in a contract in accordance with the provisions of Title II;”

Neither the definition of SEF or MTF contain the words electronic, however an MTF does specifically reference “non-discretionary rules”. A voice broker (by virtue of not being a robot or computer) has no choice but to use his discretion, however so limited by rules or systems, when executing a trade. In fact best execution obligations in MiFID (depending on the status of the counterparty) positively require him to use his discretion in a way that most suitably effects the requirements of his client. It has been assumed throughout the existence of the MiFID that the definition of MTF applies only to automated trading systems. This is illustrated by the fact that trade execution on hybrid trading platforms are split between execution by using the MTF on the screen and execution by using the firm’s general trading authorization by voice. Bearing in mind the post-trade reporting of voice trades is generally submitted to the screen for liquidity and price formation purposes; this is in reality an artificial distinction.

Accordingly straight usage of the MTF definition (including the words non-discretionary rules) could lead to regulatory arbitrage by causing a migration of voice brokerage away from Europe to the US. To avoid such occurrence, the WMBA/LEBA would suggest equivalent definitions and treatment of such easy to access multi-lateral facilities for both voice and electronic trading. Of course this should not prejudice any other rules contemplated in relation to transparency, post-trade reporting or clearing, all of which can operate effectively to a greater or lesser extent with voice trading.

It should be noted that the WMBA/LEBA members' firms all currently operate multi-lateral trading venues, be they authorized as regulated firms carrying out voice trades between market participants, electronic trades on regulated MTFs or a combination of both.

With respect to any regulatory measures taken in the EU to increase the 'exchange trading' of OTC derivatives; such measures would only increase the potential for such arbitrage, not only to the United States under the SEF definitions, but also to the Far East where OTC markets are seen as the optimal mode of transactions and indeed where the case for CCPs, as we are led to believe, has yet to be proven. Therefore we would emphasise that any regulatory measures set out would need to be absolutely consistent across major regions and trading blocks.

### **Preliminary conclusion:**

*The regulatory landscape as defined by MiFID can provide valuable benefits to the trading of OTC derivatives. However, the obligations which arise from the RM, MTF and SI regimes have largely been defined in relation to equity markets.*

WMBA/LEBA would endorse the above statement.

The new MiFID regime that captures non-equity derivatives in scope needs to be specifically tailored not only to those market structures, but more importantly to the wholesale and professional market participants involved who are significantly different to the equity market participants to whom MiFID originally catered.

#### **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?**

Whilst the IDBs put a great deal of work into both drawing up and applying the MiFID rulebook, WMBA/LEBA is under little doubt that further pre-trade transparency rules would be detrimental to liquidity. As outlined in our Key Summary, we believe strongly that any such move toward on-exchange trading would drive trading away from liquid platforms and decrease hedging altogether all to the ultimate cost of end users and consequently shareholders of these firms (i.e. the general public). Having said that, and as illustrated in the course of this reply, IDBs already fulfil many key aspects of "on-exchange" trading and therefore we urge CESR to recommend revision of the definition of what an organised trading venue is in the context of the extension of MiFID to



derivatives, especially in the context of any incentives or obligation that the regulators would seek to impose on the trading of OTC derivatives in such a concept.

Further we would challenge the largely unquestioned value of pre-trade transparency as evidenced by the traditional role of the wholesale market broker to source liquidity where demanded by market participants. Clearly, the pre-trade public availability of this information would compromise the ability of both counterparts to execute the transaction. Additionally, as many OTC derivative trades have layers of components, the actual trading price of some elements is actually not known until after the transaction is executed. Therefore, the pre-trade disclosure of prices cannot be mandated as they may only be arranged after the underlying economics of the deal have been struck and confirmed. This is the very nature of the wholesale OTC marketplace and illustrates the challenges and difficulties facing the CESR Committee in transposing a pre-dominantly retail focused regulatory regime onto a wholesale and professional framework.

Therefore in the context of MiFID, only post-trade transparency should be considered. Issues surrounding trade disclosure against liquidity then come into play and these have been closely examined in the submissions to DG Markt surrounding the post-trade architecture.

As we mentioned above, the timely publication of aggregated price and volume data across OTC products can make a substantial contribution to liquidity whilst preserving pre-trade anonymity and market liquidity. With market evolution and innovation the flexibility of the OTC markets are well placed to maintain the flow of information to supervisors and regulators.

The publication of either individual pre-trade transactional or position level data would directly damage liquidity because of the competitive nature of the trading environment. Again, we would cite the imposition of TRACE into the corporate bond markets in the US shortly after 2000 as an example whereby the regulatory environment penalised those facilitating customer and hedging flows. IDBs are not in a position to either access nor publicise position level data which remain within the responsibilities of national supervisors.

**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.**

WMBA/LEBA do indeed consider that the MiFID requirements need to be refined and as described above, specific attention needs not only to be directed towards the bespoke nature of the additional markets being considered, but also to the nature of the participants authorised to deal in such.

The wholesale nature of the products, trades and the participants leads to a necessary flexibility in regime and a focus on the behaviour of the participant rather than upon the venue of trading or the product traded. As such, the gains to be made in standardisation are located in the post-trade environments of legal certainty and post-trade processing. Initiatives at the point of trade need to be focused on utility and therefore participant led.

### **Assessment of existing market-led and regulatory initiatives promoting exchange trading**

*# FSB, a working group led by the Committee on Payment and Settlement Systems (CPSS), IOSCO and the European Commission (EC) was formed to assess and set out policy options for promoting increased use of standardised products and for developing a clear process to implement at the global level mandatory clearing and exchange or electronic trading requirements. The work will cover definitions of product standardisation, clearing-eligibility and electronic-trading-eligibility, the relationship between product standardisation and policy objectives; and analysis of how policies to incentivise a shift to clearing of standardised products may be consistently implemented at the global level. The working group will suggest policy options to the FSB in October 2010.*

#### **Q26:**

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

Taking the term "exchange trading" in its most literal sense, other than the initiatives led by those having a clear commercial interest in a forced migration to an on-exchange environment, WMBA/LEBA are not aware of any market-led initiatives to promote on-exchange trading. On the contrary, it is becoming increasingly clear that most market participants are not in favour of such an event. As mentioned frequently elsewhere in our reply, we would view such "initiatives" as only detrimental to the entire marketplace seeking to mitigate risks as efficiently as possible, and in direct contravention to the overall goals of regulatory reform.

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## **Preliminary conclusions: assessment and policy views on 'exchange trading'**

*Exchange trading offers a number of benefits that address the concerns raised by the financial crisis and that fulfil the objectives determined by governments at global level within the G20: to improve transparency, to lower risk and to ensure greater market integrity on derivatives markets.*

WMBA/LEBA would note that this response outlines why the above statement is patently false. Whilst trading on-exchange is deeply symbiotic with the OTC markets, it offers absolutely no benefits that could address the concerns raised by the financial crisis.

*Moreover, voice broking services are still being used and important for these ad hoc transactions and electronic organised platforms would therefore not meet the needs of the industry in this respect. It is important to ensure that bespoke contracts may be designed to address the industry and corporate specific needs for risk hedging and therefore not appropriate to impose their trading on electronic organised platforms.*

WMBA/LEBA would note that this response outlines why voice and hybrid brokerage services are fundamental to the functioning of the global financial marketplace and advantageous to wholesale market participants and end users alike. Contrary to the CESR Committee's misinformed view of such transactions as being "ad-hoc," voice and hybrid brokerage services currently form a highly significant portion of the globally executed OTC derivatives market. Additionally, voice brokerage services provide price formation which contributes to the liquidity generated on fully electronic platforms and provides all participants with the desired utility on a free, fair and non-discriminatory basis with immediate connections to fully electronic post-trade services. In addition to voice and hybrid brokerage service providers being highly regulated and in full compliance with MiFID, our members' activities are also entirely in accordance with the United States definition of "Swap Execution Facility."

**Q27.**

**Which kind of incentives could, in your view, efficiently promote greater trading of standardised OTC derivatives on organised trading venues?**

**Please elaborate.**

Our previous challenge to the value of the concept of standardisation notwithstanding, our members are devoted to the provision of a wide variety of pre-trade, execution, and post-trade services for our global wholesale customers. Our members are not waiting for any perceived or anticipated regulatory reforms to facilitate the deployment of services to support the OTC derivative market operations. Indeed, many of the market reforms now in place have been delivered by the IDB community irrespective of regulatory pronouncements. Therefore we view our mission to provide a range of trading services

to be complementary to, and not dependent upon, regulatory reform. As highlighted in our response to the EMIR paper, a key component in the wider acceptance of transactions being executed on organised trading venues is the fair, open and non-discriminatory operation of central clearing facilities.

**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.**

As stated throughout our response, given the commitment of CESR and market participants to the certainty in legal processes, reliability in post-trade processing, reporting and transparency, and in light of the unparalleled collaboration emerging out of well-intentioned industry working groups, we would consider the case for mandated regulatory action to be weak. The current environment of co-operation and consensus renders unlikely the need for mandated action.

WMBA/LEBA must therefore commend to the Committee that the regulatory focus be targeted at the post-trade environment and the prudential supervision of market participants.

## **IV. Annexes: The importance of the OTC markets and the Role of the Broker**

### *Annex 1*

#### **OTC and Derivative Markets**

The wholesale OTC markets offer a deep and liquid trading venue for professional market participants, such as major banks and financial institutions, to execute transactions, the key terms of which are normally individually negotiated. A difference should be noted between building liquidity in flow markets such as voice executed benchmark products and products accessible via MTFs) and non-continuously liquid markets where voice brokered markets alone play the crucial role. After more than three decades of virtually continuous growth the wholesale OTC markets are, to say the least, very substantial in both volumes and numbers of transactions. Estimates of daily average individual OTC transaction totals are widely accepted to approximate two million individual trades corresponding to approximately \$5 trillion in volume across the range of FX, interest rate, credit, equity and commodity asset classes in both cash and derivative forms (*ICAP: the Future of OTC Markets, BIS: OTC derivatives market activity in the second half of 2008*). As such, it is no surprise that asset class innovation tends to originate within the OTC space.

Factors that have significantly impacted the continuing evolution of the OTC markets over the past decade, and in particular the post-trade environment, are:

#### **(1) The growth of derivatives trading:**

The lower capital utilisation of derivatives makes these products a more efficient and attractive medium for trading than cash markets for many market participants. For this reason, trading volumes in derivatives are frequently a multiple of volumes in the equivalent underlying cash markets. Admittedly, in comparison with the cash markets, OTC derivatives transactions have historically created (a) more complex and longer-lived operational workloads, (b) medium or long-term contingent credit risk for participants on each other and (c) slower trade affirmation/confirmation procedures that can create time delays between a transaction being executed and it being officially recognised in the books and records of each counterparty. As we can all attest, significant measures across multiple constituencies have been taken, and are being taken, by the industry to address these problems (from, for example, such steps as the creation of MarkitWire and the development of the ISDA Collateral Support Annex to the initiatives of the

Commission's Working Group on Derivatives). Certainly, the explosive growth of OTC derivatives has marked not only the dynamics of how all assets classes are transacted but all these issues have also increased the complexity of the operational tasks facing all OTC market participants and have created significant capacity challenges for their middle and back offices.

### **(2) The growth of electronic trading:**

Electronic trading has developed in many liquid, mature OTC markets as commoditisation, competition and narrowing bid-ask spreads oblige market participants (including IDBs) to find cheaper and more efficient execution channels for benchmark products for both themselves and their clients. Electronic trading also greatly increases the transparency of price formation and the resulting market activity. When electronic trading is introduced more advanced trading techniques become possible, such as model-based or low latency algorithmic execution. These enterprising tools boost trading velocity which in turn drives both steep volume growth and the increasing ticket numbers which have been the target of regulatory reforms.

### **(3) Increasingly sophisticated investors:**

In recent decades, demographic change in the form of globalisation as an educational tool and spur to higher expectations, the availability of a wider array of financial products, the search for yield and the growing focus on absolute returns rather than meeting index performance has led to a seismic shift in the asset management industry generally and rapid expansion in the hedge fund industry in particular. This in turn fostered rapid growth in prime broking where the consolidation of borrowing, clearing, netting and settlement allowed more astute investors to widen their scope (and, over time, were seduced by generous leverage terms to over extend themselves). Now, however, the Infrastructure that supported the prime brokerage industry has been called into question due to perceived concentration and counterparty risks. Nonetheless, the genie escaping from the bottle to expose end users to an array of derivative products will be a permanent fixture of the derivative markets going forward and, indeed, the requirement from these investors for bespoke products and hedges will ensure that derivatives remain a predominantly OTC market for the foreseeable future.

To expand upon this point further, the bespoke and individually negotiated nature of OTC contracts makes them much more attractive, and suitable, for hedging risk, especially in financial markets. Since exchange contracts are standardised and "real world" economic risk is normally non-standardised, traders and end users who access exchanges for hedging purposes will continue to carry the differential between their real underlying exposure and the delivery dates on their hedges. As a result, exchange contracts very rarely provide a perfect hedge for actual economic risk. By contrast, users of the OTC markets can hedge their risk precisely and transfer to professional

OTC market participants their full exposure including the residual risk they would otherwise be forced to bear if they had used an exchange product. This treatment also has important financial accounting consequences. Accounting standards set tests for “hedge accounting” that require very close, or exact, matching of underlying risk with hedges for those hedges themselves to be allowed for capital optimisation purposes. These standards therefore oblige companies and other entities that are subject to these rules to use OTC markets rather than exchange products on most occasions.

#### **(4) The relationship between the OTC markets and the exchanges**

The relationship between the OTC markets and the exchanges is often portrayed as competitive, but is in reality more often symbiotic. Certainly the peaks in either outstanding OTC volumes or global exchanges open interest would not have been attainable without the other. As we know, OTC and exchange markets each have separate, distinctive and logical reasons to exist, each of which has been reinforced by the recent market turmoil. One aspect of the professional OTC market which has contributed to its growth relative to the exchange world is the existence of “information symmetry” where the multiple information channels, hybrid execution venues and widely publicised trading prices renders access relatively equal for wholesale market participants. In the exchange arena, the mass arms race led by the most experienced “member” participants to control access to best prices, either in the form, for example, of lightning fast latency or privileged access to specific ‘dark pools’, renders competition more uneven. This sense of openness has been an important factor in the proliferation of the OTC sphere in our generation and will continue to hold sway going forward.

#### **(5) Regulation and Supervision in OTC Markets**

All participants in wholesale OTC markets are professional in nature and are closely regulated as such. This allows the supervision and regulation of OTC markets to focus upon the market participants themselves rather than upon the products traded. It is critical to emphasise that both regulators and national supervisors can and do investigate trades conducted at IDBs to the same extent as at exchanges. The Basel II Accord sets out the framework for the supervision and regulation of these participants by setting up rigorous risk and capital management requirements designed to ensure that a bank holds capital reserves appropriate to the risk to which the bank exposes itself. Generally speaking, these rules mean that the greater risk to which the bank is exposed, the greater the amount of capital the bank needs to hold to safeguard its solvency and overall economic stability.

This uniform regulation leads to an absence of regulatory arbitrage in the OTC marketplace. In virtually every commodity or asset class a wholesale market exists alongside a retail market. The wholesale market exists to allow major participants to

assume and lay off risk between themselves in bulk. The retail markets exist to allow smaller participants to assume and lay off risk in the much smaller and specific quantities and description that they need. It is no accident that the two co-exist alongside each other. This symbiosis has also been fundamental to the expansion of the OTC markets. Forcing either large market players to lay off risk in a retail market or small market participants to use the wholesale market, as would be the case by mandating OTC products be transacted in an exchange environment, creates much bigger risk than separating the two sets of players into complementary markets.

Despite the fall-out from the recent financial crisis whose root causes as mentioned above lie principally not in derivatives per se but rather in structured credit products, their accounting and the behaviour of credit rating agencies, the development of the OTC markets has enhanced dramatically global risk mitigation and has contributed mightily to global economic growth over the past 25 years. A lack of comfort in credit and other derivatives is in our view a symptom of the underlying problem rather than its cause. It is important to distinguish between ineffective supervision of individual market participants and changes to, or the regulation of, market structure itself. The fundamental point is that the market crisis was caused by a lack of confidence in financial reporting and by the actions of individual market participants – not by a lack of confidence in market structure or processing. No market structure – neither OTC nor exchange – can determine the correct price for, for instance, a one-month unsecured inter-bank loan if there is material uncertainty about the repayment of that loan caused by overwhelming concern about the real or imagined financial state of the borrower as evidenced by its financial reporting.

The distinction is often made between “regulated” and “unregulated” markets, with exchange markets often presented as “regulated” due to the fact that exchanges are mandated to regulate the content, behaviour and participation in specified products. However, again, the perception that OTC markets are unregulated is incorrect. In contrast to exchanges, the primary regulatory focus in OTC markets is on the participants themselves based on their activity, the nature of their counterparties and type of assets involved.

The CRD extends not just prudential principles but also systems and control requirements to all international parts of regulated groups that have EU headquarters. Automated Trading System and Multilateral Trading Facility regulations under MiFID and equivalent US and international regulations impose additional layers of regulation on electronic markets over and above the usual “regulated firm” rules that apply to operators and participants. The OTC derivative market’s rules of operation, valuation and netting have been agreed by trade associations in conjunction with regulators – such as the Master Agreements published by ISDA, the Securities Industry and Financial Markets Association (SIFMA), and the International Securities Lending Association (ISLA), all of which have been recognised by regulators, most importantly in the EU and



US, as a valid basis for netting exposures for regulatory capital and risk reporting purposes.

OTC market activity is also itself subject to extensive codes of conduct set by regulators such as the NIPs Code in the UK, the multiple rules that have been created since MiFID, and international codes of best practice such as those produced by the Financial Markets Association (“ACI”). It may be tempting to regard the “regulated market” as the more robust model, but while exchange rules are certainly aimed at ensuring orderly markets.

### **Conclusions**

Innovations in risk management originating in the wholesale markets, including clearing, have had a profound and hugely beneficial effect on the way in which corporations, investment firms and governments manage their financial risks. The more efficient allocation of resources and freer flow of capital that these tools have allowed has dramatically increased predictability and stability in government, corporate and individual financial planning and enabled much more rapid growth in the global economy relative to what would have been achieved without them.

The effects have been profound, down to the level of many millions of individuals around the world and the way they manage their personal assets, liabilities and retirement funds. Accordingly, the consequences of any changes to the structure or operation of the OTC markets need to be very carefully considered. We reiterate that the laws of unintended consequences may lead to increased costs of capital and reduced hedging capabilities for all participants and end users alike.

Annex 2

**What Is An Interdealer Broker And What Value Do They Add To The Market Infrastructure?**

The main business of an IDB is to provide access to OTC and/or exchange traded pools of liquidity, across a full range of asset classes and their associated derivatives. Typically, brokerage activity takes place in the wholesale financial markets, which includes cash deposits, financial derivatives, securities, equities, commodities, energy, emissions and credit.

The primary function of a broker is to act as an intermediary through which wholesale market participants can conclude transactions by the bilateral matching of their trading needs with other wholesale market participants having reciprocal interests.

Typically, counterparties within these markets would be wholesale market participants consisting of investment banks, primary dealers, leading regional banks, high volume trading companies, government agencies and fund management firms, and would not include any retail clients as defined under the FSA rules.

Prices, orders and expressions of interest will be communicated across a variety of mediums - often hybrid - including telephone, electronic display screen, or fully electronic trading system (Multilateral Trading Facility ("MTF") as defined by MiFID).

In each market, brokers will communicate to all the counterparties whether bids and offers are 'firm' or 'indicative'. In most cases unless otherwise stipulated during the course of dealing, market quotes provided by brokers represent live, tradable prices based on counterparties' bids and offers and market information then available.

Brokers will endeavour to match the counterparties trading requirement or orders with other trading interests in the market. Normally this means that brokers can only give the counterparty access to their own liquidity internal pools, and will pass prices or orders to and from its other counterparties to its own voice brokers or display these clusters of prices on its own electronic trading systems. In addition, brokers may use "link" brokers with whom they have a commercial relationship in order to extend their reach (for example across geographic lines where one broker may not have a presence) and arrange a trade between their own counterparty and a client of the linked broker.

Brokers, as instructed, will arrange trades on behalf of a counterparty, based either on a price or order that the counterparty has placed with them, or as confirmed by the counterparty following a period of negotiation.

Brokers may utilise price dissemination screens in their role as voice brokers, and illustrate an actual or indicative mid-market or bid or offer price based on actual trading,

orders and expressions of interest. While brokers intend to provide counterparties with the most accurate and reflective view of current price levels in all market conditions, it may not always be possible to actually trade at the displayed prices if a corresponding order is not then available due to temporary volatility. Market participants fully understand these nuances of dealing practices.

Unless otherwise communicated to the counterparty before trading, all orders submitted to a broker's MTF platform will be traded on price/time priority. Counterparties will also be able to view full order depth. Execution occurs on the basis of active acceptance of orders in the system submitted by other users. Eligibility, trading methodology, instrument descriptions and credit parameters are all set out in the user terms for the relevant MTF.

Prices are given and trades executed, either excluding brokers' brokerage (i.e. a clean price) or via a net price including commission. Brokerage rates are as agreed between the counterparty and the broker by product, often with volume discounts or other fee discounts based on market making activity.

To facilitate this transaction activity brokers engage their clients on both an electronic and voice basis. In most cases brokers arrange trades on a 'name give-up' basis where the identity of the counterparties is exchanged post-trade. However there are two other brokerage business models: 'matched principal' and 'exchange give-up'. Here is a more detailed description of these three options:

### **Name Give-Up**

The name give-up brokerage model is the traditional model, through which the broker takes on an arranging role in a transaction between two or more counterparties. The broker, through price dissemination, distributes quotes to other market participants showing both price and volume. As outlined above, for voice brokered products these prices and volumes are dependant upon market convention, either firm or indicative levels of interest, and must be confirmed prior to the trade being completed. For electronic products brokered through MTFs, these prices and volumes are typically firm and are traded without further communication.

Once the trade price, volume and terms have been agreed, either through further conversation with the broker or with the direct hit or taking of prices on an MTF, the counterparties' names are disclosed and the broker steps away from the transaction. Bilateral agreements are then enforced between the counterparties and the broker will invoice the brokerage fee on a monthly basis or extract the commission at the point of sale.

### **Matched Principal**

In the matched principal model, the broker facilitates its clients in anonymous trading activity by taking part in a matched transaction as principal, becoming the buyer to the seller and the seller to the buyer. The broker's own credit with its counterparts and the nature of its netting and settlement procedures will determine the amounts that be executed in this manner.

While operating as matched principle the broker will not trade speculatively for a client or for his own book. The trade will only be executed as a result of a firm client order to buy or sell at a set price or size. Once the trade is complete, price, volume and terms are communicated through the broker and back office confirmations.

Similar to the name give-up format, settlement is made between each client based on the market convention with the brokerage fee being either incorporated in the all-in price passed to the client through a disclosed brokerage agreement or through a monthly invoice.

### **Exchange Give-Up**

In addition to name give-up and matched principal brokerage models, brokers can facilitate the trading activity of their clients on derivative exchanges (e.g. LIFFE, Eurex, CME, etc). In this instance the broker may engage in exchange trading in the capacity of an 'Executing Broker' as defined in the FOA's International Uniform Brokerage Execution Services ('Give-Up') Agreement, and give-up the trade to a client's clearer immediately following the execution of the transaction. Under this 'exchange give-up' model the broker is subject to intra-day exposure of this 'agent' position until the trade is accepted by the counterparty. This 'give-up/pick-up' arrangement is standard in all exchange traded products.

Procedurally, upon receiving the relevant price information from the broker, the client will instruct the broker to place an order on the appropriate exchange, either in its own name (if a member of the exchange) or through a third party clearing member or GCM. The broker can provide the client with an indication of the market based on the current price and volume activity on the exchange.

### **The Value of Interdealer Brokers to Market Infrastructure**

As outlined above, IDBs are companies that serve as intermediaries which facilitate transactions in the OTC markets between dealers and banks in a variety of financial instruments.

IDBs add value to the markets by:

1. Enhancing price discovery and transparency
2. Increasing pricing confidence
3. Protecting clients' interests
4. Providing anonymity and confidentiality
5. Managing complex trades
6. Facilitating information flow
7. Facilitating enhanced liquidity
8. Improving market efficiency
9. Delivering multi-lateral electronic trading and settlement solutions
10. Lowering costs for customers

### **Price Discovery and Transparency**

IDBs facilitate the execution of transactions by providing global pre-trade price discovery in various markets. Prior to execution, an IDB distributes its prices gathered from dealers with market interest in the form of bids and offers through a variety of methods ranging from custom-designed trading platforms to other forms of electronic communications and by voice.

The broker aggregates price information in order to show its dealer clients the best quotes available in the marketplace. Dealers use this information to trade for their own account and to facilitate customer transactions.

The publishing of prices improves price and trade transparency and discovery and with the ultimate goal of bringing multiple buyers and sellers together at one price. Such information is vital in emerging or complex markets that depend on this IDB price transparency not only for trading but also for valuation of portfolios.

### **Price Confidence**

In many markets, especially immature or complex markets, there may be many instances where dealers are not certain that a particular instrument has been priced correctly and so the price is checked with an IDB. The advanced models that the IDBs use and their wealth of experience in a cross section of markets enables them to act as a 'safety' valve for the bank dealer ahead of his quoting or executing a client trade. This value added service is unique to IDBs and not possible on-exchanges as IDBs are able to

confirm or correct a dealer price as well as have hedge strategies lined up and ready to execute on his behalf in the event that the dealer executes his client trade.

### **Protecting Clients**

One of the most valuable functions of IDBs is their ability to protect dealers from accidental and erroneous trades or even malicious transactions. In their unique position as gatekeepers, intermediaries and facilitators of trades IDBs are able to protect their clients' interests by virtue of a total market overview. Similarly, in cases of unusual market volatility IDBs are preferred because the brokers are rapidly able to change a dealer's quote to match these volatile or gapping market conditions. The re-emergence of voice brokerage services at the expense of electronic trading was extremely evident when post-Lehman volatility reached its peak and dealers sought the protection and price discovery offered by voice brokers.

### **Anonymity and Confidentiality**

An IDB maintains absolute client anonymity during the price discovery process in order to prevent competing dealers from discerning each other's strategies by attempting to monitor the market activities of their competitors. The IDBs thereby prevent prices from being adjusted pre-trade based on the knowledge of participating counterparties. This is in accord with the observance across all the IDBs of the previously referred to Bank of England's NIPs Code."

During price discovery, dealer interactions with IDBs are not revealed to the marketplace. This anonymity reduces the market impact costs associated with the value to the market of the knowledge that a particular dealer is seeking to execute a particular trade.

### **Managing Complex Trades**

Most non-standardised or non-commoditised instruments are traded through the IDB OTC market as these orders enjoy a high level of complexity that may be optimally managed by human interaction and/or the highly sophisticated IDB electronic systems built specifically to function in high velocity, multiple buyer/seller environments. IDBs are able to arrange multi-legged trades and dynamic hedges to simultaneously execute these across multiple instruments and asset classes so as to provide a dealer with a trade that is tailored to his particular requirement or that of the dealer's end-user.

### **Facilitating information flow**

An IDB's role in facilitating the flow of information between dealers is a critical service which both enhances liquidity and results in improved prices for market participants. Pre-trade, IDBs facilitate market information flow in a number of ways. IDBs post and disseminate market information through and their own electronic systems or such

market data providers as Reuters and Bloomberg to their dealer clients. By providing anonymity to their dealer clients, IDBs thereby encourage dealers to supply the IDB with market information, and so the IDB is likely to have a more complete composite picture of the market than any one dealer or combination of dealers. Finally, by aggregating this information in conjunction with price quotations, IDBs provide participants with valuable information that reflects the real-time state of the market. IDBs also facilitate post-execution price transparency by reporting trades, volumes and direction. As a result, market confidence levels increase and more market participants are attracted to trade.

### **Enhancing liquidity**

In financial markets there are numerous factors that affect market liquidity ranging from price uncertainty to credit worthiness to availability of an underlying hedge instrument to a lack of available capital due to balance sheet restrictions to temporary disruptions in market behaviour. As IDBs act as agents and provide dealers with quotes from other dealers, they enhance the information available to the market and the market's overall efficiency. Thus, IDBs facilitate trades and ensure a more liquid market. Peer group competition among IDBs means that overall liquidity is further enhanced because there are free flowing, decentralized pools of liquidity which wholesale market participants can access.

IDBs are able to create liquidity where such liquidity did not before exist through their ability to view multiple markets simultaneously across the dealing floor and derive prices from complementary marketplaces. This wide vision enables IDBs to execute cross asset trades and to provide liquidity in an otherwise illiquid market by spreading the trade components against other products which may trade in a more liquid market. Examples of this would be the trading of USD interest rate swaps against US Treasuries where a price in one would generate a price in the other. Another example would be in delta hedging of swaptions where a tradable price on the option would generate an executable price on the swap and vice versa.

### **Improving Market Efficiency**

By definition, in illiquid markets trading activity does not occur with regularity. As the IDBs have real-time knowledge of the market participants, their underlying interests and their trading activity, constant communications with the brokers enables dealers to trade given the smallest window of opportunity. For traders, the timesaving element of working with IDBs and the IDB's ability to execute rapidly will make the difference between executing and missing a trade for dealers and by extension for their customers.

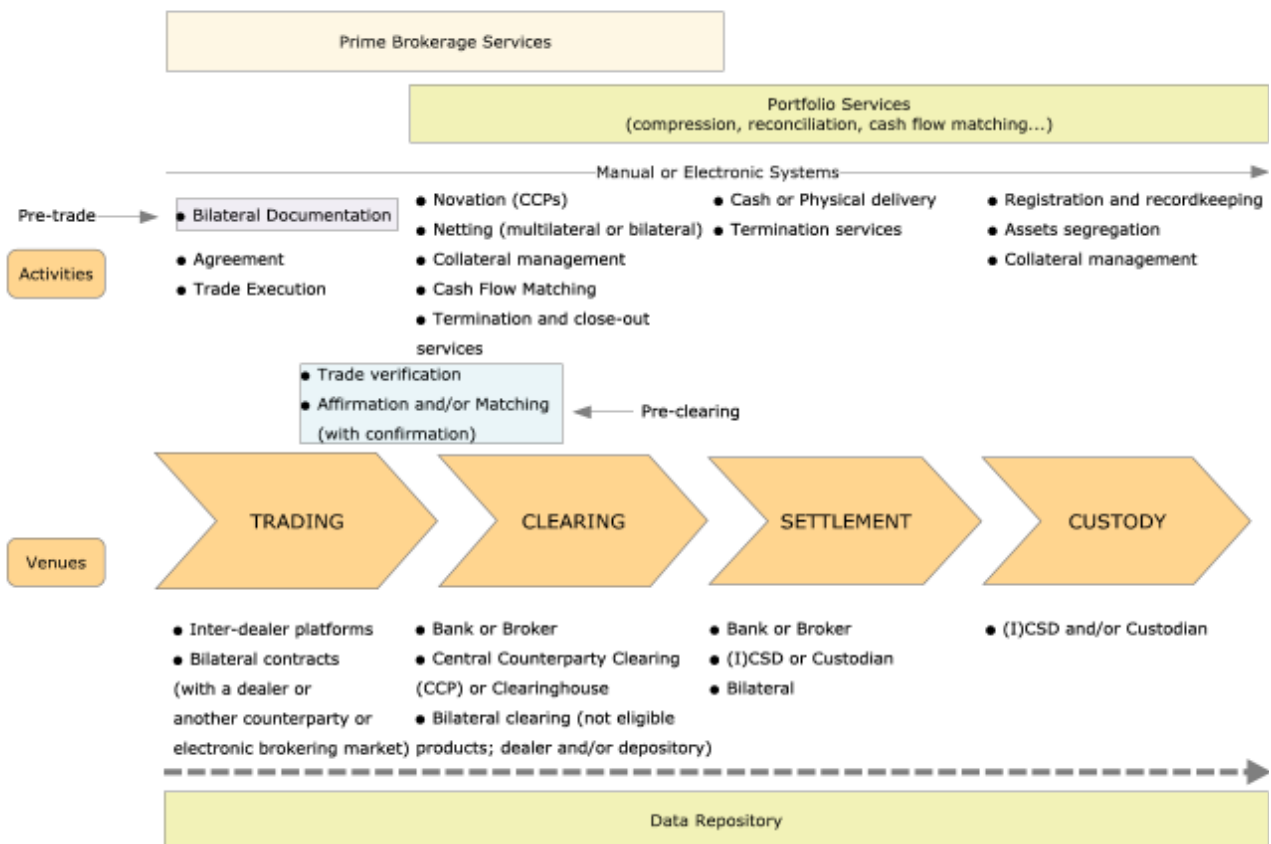
### **Lowering Costs**

By collecting information from dealers on an independent basis, interdealer brokers gather the available liquidity for a particular instrument. This function often serves to

make available a sufficient, tradable amount for often illiquid securities. This practice not only creates transactions that would otherwise not occur, the combining of 'odd lots' into 'round lots' serves to lower search costs for dealers. As mentioned above, without IDBs, dealers would be in the position of having to expose their identity to the marketplace as they search to gather and combine amounts in liquid sizes or gather together the various components of a multi-legged transaction. The public disclosure of this information might not only prevent them from operating successfully in the market, it would also serve to impair their bargaining position and directly raise net costs.

Additionally, many trades involve the simultaneous execution of more than one instrument such as a bond against a future or a swap against a bond or a futures cross. IDBs may not charge commission for each of these legs independently but rather may invoice a fee for only one leg thereby saving the dealer a significant amount which he would be able to pass on to his end customer.

Figure 5. OTC derivatives transaction







WMBA/LEBA Response to CESR on Standardisation and exchange trading of OTC derivatives

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Annex 3

**Letter from WMBA LEBA to CPSS-IOSCO on the efficacy of clearing infrastructures**



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Tuesday, 17 August 2010

**To:**

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Bank for International Settlements; Secretariat; Takeshi Shirakami ([cpss@bis.org](mailto:cpss@bis.org))

**CPSS-IOSCO OTC derivatives CCP**

In response to the above recommendations on CCPs published in May 2010 the Wholesale Markets Brokers Association (WMBA) and London Energy Brokers Association (LEBA) would wish to respond with comments related to free and fair access from an execution facility into a CCP.

**Recommendation 2: Participation requirements (p. 11)**

Whilst the WMBA/LEBA endorse paragraph 4.2 that "A CCP's participation requirements should be objective, publicly disclosed, and permit fair and open access;" we would hope for specific guidance on the role of the Interdealer Broker (IDB), as a regulated and compliant trade execution facility, to be able to pass eligible matched trades up to a CCP. Access to a CCP should be open to multiple types of trading formats including bilateral/voice brokered trades, fully electronic OTC executions, and on-exchange transactions. Ownership of a trading platform by a CCP should not be subject to favourable treatment as this would not only severely restrict competition but more importantly

could negatively impact the terms and conditions under which market participants are able to manage and reduce risk.

This becomes especially critical where the product traded is defined as “Clearing Eligible” where there may be only a single suitable CCP. Credit Default Swap Index trades such as ITRAXX may be such an example where ICE Clear Europe has a dominant role in the clearing of this product. WMBA/LEBA therefore recommends that the language in the final CPSS-IOSCO document makes specific reference to ensuring that IDBs will be able to deliver all eligible products in a format acceptable to any CCP regardless of the execution format.

#### **Guidance 12.2. Efficiency implication of decisions on links with multiple venues**

##### **(p. 22)**

With regard to the permission of fair and open access to clearing, it becomes critical for the business model of the IDB under a mandatory regime to be able to offer its trade execution and matching services.

*We note the guidance “In OTC derivatives markets, where trading could occur over multiple venues, it is important for a CCP to conduct a thorough analysis of risks, costs and benefits (including potential benefits to the overall market) of accepting and clearing trades that are executed or processed at different venues, such as exchanges, electronic trading venues, TRs and confirmation matching platforms.”*

WMBA/LEBA are highly concerned that this provision is allowing, and will allow in the future, the CCP to favour its own vertically integrated matching platforms to the exclusion of alternative venues such as IDBs and MTFs.

Where there is little or no competition between CCPs and where a CCP also owns an execution platform we remain concerned that the utility function may be compromised by commercial objectives. It is important to allow flexibility of access to any CCP as market participants may continue to execute large OTC transactions through WBMA/LEBA members where give-up into a CCP is required.

The overall growth and acceptance of electronic trading systems is likely to continue while the “price-search” function may prove in some markets to remain more efficient in the voice brokered arena. For this reason, no CCP should be in a position to refuse such trades. To avoid long delays in granting access initial requests to submit certain type of trades to an eligible CCP should be restricted to a very short period (2 weeks) so as to provide certainty for market participants. When such permission is granted there should be a strict regime for withdrawal from the CCP after market consultations and notification of the regulators concerned.

Currently, with both NYSE.LIFFE and the LSE announcing intentions to build a vertically integrated CCP, we note that the potential for further silo creation within the industry may be encouraged by existing CPSS-IOSCO guidance not only through delayed or deferred prudential analytical processes, but also through preferential access to the integrated trade processing technology such as the Application Program Interface (API) which governs the acceptance and processing of trades.

WMBA/LEBA note with alarm that when asked last week about their vertically integrated execution clearing models and closed access, senior management of both ICE and Eurex indicated that they would be reluctant to unbundle these services in terms of both fees and API access unless legally obliged to do so. With reference to the EU Internal Market, we question whether such actions may prima facie be a breach of the Code of Conduct ([http://ec.europa.eu/internal\\_market/financial-markets/docs/code/code\\_en.pdf](http://ec.europa.eu/internal_market/financial-markets/docs/code/code_en.pdf)).

- |    |  |
|----|--|
| 27 | Access should be granted on the basis of non-discriminatory, transparent criteria and prices |
| 28 | Requests for access should be treated expeditiously  |
| 29 | The process under which access requests are to be treated should be publicly available.      |

Consequently WMBA/LEBA would wish for CPSS-IOSCO to emphasise strongly that the authorisation process for the acceptance of eligible transactions into any CCP is the responsibility of the prudential authorities and not the individual CCP management. Lastly, in order to promote competition and the optimal use of capital, WMBA/LEBA endorse the full interoperability between clearing houses.

Regards,

**Wholesale Markets Brokers' Association**

**London Energy Brokers' Association**

*Annex 4*

**WMBA/LEBA Membership**

1. BGC Partners
2. EBS Group
3. GFI Group Inc.
4. ICAP plc
5. Martin Brokers (UK) Ltd
6. Reuters Transaction Services Ltd
7. Sterling International Brokers Ltd
8. Tradition (UK) Ltd
9. Tullett Prebon Ltd
10. APX Power UK
11. CantorCO2e Ltd
12. Evolution Markets Ltd.
13. GFI Group, Inc
14. ICAP Energy Ltd
15. PVM Oil Associates Ltd
16. Spectron Group Ltd
17. Tradition Financial Services Ltd
18. Tullett Prebon Energy Ltd
19. Vantage Capital Partners

Annex 5

**MTFs and Electronic Matching Systems Operated by WMBA/LEBA Members**

<u>MIC Code</u>	<u>Full Name</u>	<u>Country Code</u>	<u>Authority Name</u>
BGCI	BGC BROKERS LP	GB	FSA
BLOX	INSTINET BLOCKMATCH	GB	FSA
BTEE	ICAP BROKERTEC PLATFORM	GB	FSA
CCO2	CANTORCO2E	GB	FSA
GFIC	GFI CREDITMATCH	GB	FSA
GFIF	GFI FOREXMATCH	GB	FSA
GFIM	GFI MARKETWATCH	GB	FSA
GFIN	GFI ENERGMATCH	GB	FSA
ICAH	ICAP HYDE DERIVATIVES TRAYPORT PLATFORM	GB	FSA
ICAP	ICAP ISWAP PLATFORM	GB	FSA
ICAS	ICAP ENERGY	NO	Kredittilsynet
ICEN	ICAP ENERGY TRAYPORT PLATFORM	GB	FSA
ICSE	ETC/BROKERTEC PLATFORM	GB	FSA
ICSE	ICAP SECURITIES	GB	FSA
RTSL	REUTERS TRANSACTION SERVICES LIMITED	GB	FSA
SPEC	SPECTRONLIVE TRAYPORT	GB	FSA
TBEN	TULLETT PREBON ENERGY (TREASURY & DERIVATIVES)	GB	FSA
TBEN	TULLETT PREBON ENERGY (UK)	GB	FSA
TBEN	TULLETT PREBON PLC - TULLETT PREBON ENERGY	GB	FSA
TBLA	TRADEBLADE (SECURITIES)	GB	FSA
TBLA	TRADEBLADE (TREASURY & DERIVATIVES)	GB	FSA

*WMBA/LEBA Response to CESR on Standardisation and exchange trading of OTC derivatives*

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TBLA	TULLETT PREBON PLC - TP TRADEBLADE	GB	FSA
TCDS	TRADITION CDS	GB	FSA
TFSG	TFS GREEN SCREEN	GB	FSA
TFSS	TFS VARIANCE SWAPS SYSTEM	GB	FSA
TFSV	VOLBROKER	GB	FSA
TNLB	TRADING FACILITY	BE	CBFA
TPCD	TULLETT PREBON PLC - TP CREDITDEAL	GB	FSA
TPRE	TULLETT PREBON PLC - TP REPO	GB	FSA
XGFI	GFI BASISMATCH	GB	FSA