WMBA/LEBA Response to European Commission Communication on Derivatives.

"Ensuring Efficient, Safe and Sound Derivatives Markets"

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WMBA/LEBA Response to European Commission Communication on Derivatives.

"Ensuring Efficient, Safe and Sound Derivatives Markets"

Part 1: Executive Summary

1. The Wholesale Market Brokers' Association ("WMBA") and the London Energy Brokers Association ("LEBA") are the European industry association for the Interdealer Brokers ("IDBs") in the Over-the-Counter ("OTC") financial, energy/commodity, equity, credit, cash and derivatives products. Together the associations have eighteen members comprising the entirety of the IDB sector, which are listed in appendix three (www.wmba.org.uk and www.leba.org.uk). WMBA and LEBA members are limited activity firms that act as intermediaries in wholesale financial markets, with a principal client base made up of global banks, primary dealers, leading regional banks, asset managers, oil companies, energy generators and transmission operators.

Replies to the consultation paper should be seen in the context of member firms acting exclusively as intermediaries, and not as own account traders. For this reason some of the questions in this Consultation Paper are not entirely relevant to WMBA/LEBA member firms activities, although they are to most of their clients, and some answers take into account industry views and experience.

2. In drafting this response, WMBA/LEBA has maintained its usual cooperation with the Futures & Options Association ("FOA"), the International Swaps and Derivatives Association ("ISDA"), the Foreign Exchange Joint Standing Committee on the Bank of England and the City Corporation of London. We acknowledge that these entities are submitting their own responses to the EU Consultation Paper and in order not to duplicate comment we endorse and support most of those submissions in addition to the comments made herein.

3. WMBA/LEBA supports the Commission's 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 Commission's assertion that the "**Derivatives Markets**" have been at the centre of the financial crisis. Whilst Mortgage Lending and Packaging, other Structured Products, Audit Procedures, Credit Ratings and the behaviour of Credit Agencies were all fundamental the financial crisis, the OTC and Derivatives Markets themselves were the bedrock of the continuing functioning of

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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. The **Corporation of London Paper of 10 June 2009** on the relationship of OTC Derivatives to the Financial Crisis explains this fully.

5. We would respectfully ask the Commission against issuing any legislation that adds 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) land 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. We would stress the requirement for equal and open access, both commercially and technologically, to clearing on a trade-date 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.

8. We remain concerned that the Commission 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

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"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 volume 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.

9. 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. Proposed regulation therefore will 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.

10. We do not recognise the OTC, or Derivatives Markets, as opaque. Rather the sheer scope, breadth and depth of the transactions do not lead to "Bellwether Reports."

11. 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 remain non-pre-trade transparent as a prerequisite for sufficient liquidity.

12. 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 wholesale and retail marketplaces.

13. IDBs, as a dimension of the flexibility inherent in their voice and electronic brokerage venues, do now offer 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.

14. Mandating the entire wholesale OTC derivatives markets onto exchanges or regulated electronic trading systems that do not include encompass the entire product offerings of IDBs fails to recognise not only the substantial investments the IDB industry has already made to improve market infrastructure but also will discourage the industry from making such investments in the future.

15. 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, both outcry and electronic marketplaces, 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.

16. WMBA/LEBA believe that the CCPs are not in and of themselves a universal panacea and need 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.

17. 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 own 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.

Part 2: Answers to Consultation Document

Standardisation

1. **WHAT WOULD BE A VALID REASON NOT TO USE ELECTRONIC MEANS AS A TOOL FOR CONTRACTS STANDARDISATION?**
2. **SHOULD CONTRACTS STANDARDISATION BE MEASURED BY THE LEVEL OF PROCESS AUTOMATION?**
   - ***WHAT OTHER INDICATORS CAN BE USED?***
3. **SHOULD NON-STANDARDISED CONTRACTS FACE HIGHER CAPITAL CHARGES FOR OPERATIONAL RISK?**
4. **WHAT OTHER INCENTIVES TOWARD STANDARDISATION COULD BE USED, ESPECIALLY FOR NON-CREDIT INSTITUTIONS?**

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 such electronic platforms or "**Broker Screens**," 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 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. The full spectrum of clients has 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 methodology 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 both voice and electronic trades, an electronic ticket is created post-trade and registered, resulting from that point in time and the identical treatment as to those trades executed fully electronically. The choice of clearing venue and/or use of CCP facilities then depends upon the client’s wishes and requirements – 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”.

We do not agree with the oft repeated regulatory and political mantra that non-standardised contracts should face higher capital charges for operational risk. When looking at whether to apply capital penalties to non-cleared contracts, the issue at debate here is whether “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 corporate entities. 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.

Strengthening bilateral collateral management

5. **HOW COULD THE COVERAGE OF COLLATERALISED CREDIT EXPOSURES BE IMPROVED?**
6. **ARE THERE MARKETS WHERE DAILY VALUATION, EXCHANGE OF COLLATERAL AND PORTFOLIO RECONCILIATION CANNOT BE THE GOAL? PLEASE JUSTIFY.**
7. **HOW FREQUENTLY SHOULD MULTILATERAL NETTING BE USED?**
8. **SHOULD BILATERAL COLLATERAL MANAGEMENT BE LEFT TO SELF-REGULATORY INITIATIVES OR DOES IT NEED TO BE INCENTIVISED BY APPROPRIATE LEGISLATIVE INSTRUMENTS?**

Bi-lateral collateral management has been the dominant counterparty risk-management practice used by the OTC derivatives industry for the past fifteen years. Bilateral margining covers all types of OTC derivatives traded under a Master agreement (most commonly the 1992 and 2000 versions of the ISDA Master Agreements) – which includes all derivative asset classes (interest rates, credit, equity, energy, commodity, etc) and all trade types (swaps, forwards, OTC options, etc).

All users of OTC products should avail of reconciliation services. It would provide them with a better view of the evolution of the protection needed from adverse movements in products used. In particular, for the sell-side, it should be made compulsory. As an indirect result it would help the sell-side in judgment of their buy-side counterparty risk and allow faster reaction to possible default risks. Currently, there are not enough buy-side clients that use CCP services (and in some cases it may not make sense for some members of this group to do so). However, most and certainly the large buy-side financial services institutions (insurance companies, pension funds and others), that use OTC derivatives should be obliged to become members of a reconciliation service which will immediately simplify collateral management procedures.

Clearly, one of the cardinal benefits of recently devised post-trade infrastructures is the facility for both buy- and sell- sides to more easily reach this goal of daily reconciliation. As a consequence, an evaluation by reconciliation services should make it possible to provide a full picture of all outstanding transactions to relevant observers of the market.

Broadly speaking, the increased adoption of multi-lateral netting has already strengthened collateral management performance. ISDA has developed measures to improve the dispute resolution process. It also has drafted plans of a four layer global structure with representation by all market sectors. WMBA/LEBA supports this information becoming more widely available to the authorities and recommends coordinated the use of multilateral netting cycles without making the process

excessively and unnecessarily expensive. As the frequency of multilateral netting depends on the nature the currency, major currencies that already benefit from regular netting frequencies will benefit further from the encouragement to adopt even more frequent cycles, and minor currencies may need some regulatory impetus for widespread multi-lateral netting to be put in place in order to assist in optimising collateral management procedures. Ultimately, of course, it is the users that should decide - ISDA is probably the best placed association to organize this with their members with possible wider consultation with the appropriate buy-side institutions to seek the optimal use of multi-lateral netting facilities to expedite collateral and portfolio reconciliation.

Despite extensive developments ensuring the legal and operational accuracy of collateral management a number of issues would merit further attention - in particular "dispute resolution".

Dispute resolution is a necessary process to navigate a path through the complex reconciliation and valuation processes that must be applied to a diverse derivatives portfolio. Any one organisation's portfolio will have multiple counterparties with which it has traded in often similar or correlated assets. It is because of this decentralised and ultimately bilateral nature of each trade that the market bears the unintended "second order" risk of failed reconciliations and therefore potentially a series of disputes with counterparts. WMBA/LEBA call attention to this aspect (as we regularly settle disputes) insofar as the Commission may wish to incorporate references to preferred dispute resolution measures as a subset of overall comments guiding the marketplace going forward.

Most of the trades that the IDBs facilitate daily are entered under bilateral collateralised credit. We applaud the recent work done by ISDA on further simplifying and strengthening the process and mechanism of collateralisation. Further, CPS-IOSCO agrees with ISDA that whilst same day revaluations and transfer of collateral is positive and possible between banks, buy-side financial entities and corporates would not have the infrastructure available to enact such processes. Further discussions around the optimisation for both buy-side financial and corporate entities, particularly around T+1, need to be accommodated. WMBA/LEBA feels that these ongoing self-regulatory initiatives adequately prioritise efforts to improve the collateralisation process and therefore we do not recommend that legislative measures are required to address this particular aspect beyond providing guidance. Again, commercial pressures figure strongly in dictating a speedy, wider adoption of cost-effective collateral management practices.

So, bilateral collateralization will benefit all actors in the markets; as such it should become standard market practice. However, WMBA/LEBA acknowledges that there are a number of barriers, both in Europe and globally, in the area of clearing and settlement that make this not always possible (e.g. cross-currency, difference in

legal jurisdiction and protection, different time zones, varying accounting rules, etc). Within Europe, collateral management needs to be further developed by improving education. Organisations like the European Banking Federation and ICMA's European Repo Council could play a crucial role in this field. As stated above, it is doubtful that an increase in capital requirements would provide a suitable solution as many practical issues remain unwieldy. Practical work on solutions like the CESAME 2 discussion regarding the removal of private and public barriers needs to be encouraged further.

Although the creation of T2S will probably improve the collateral management environment, markets cannot afford to wait for several more years for efficiency to be introduced. To reiterate, by and large any enforced regulation will be misplaced as the overall infrastructure is not fully up to the required standard. While this project is ongoing preference should be given to a continuous dialogue and progressively more granular work towards self- regulatory solutions that will reach the desired result without disruption of what has so far been achieved.

As mentioned above, more relevant and important could be the damage done to the strength of bilateral collateral management by mandating the liquid parts of such bilateral agreements out of the netting pool and onto a CCP. This would leave only the illiquid and complex products remaining and hence increase the risk to the exposures. How to manage any exceptions to eligible instruments required to be centrally cleared will remain at the core of the widespread adoption of CCP facilities.

WMBA/LEBA agrees with the logical contention that the higher the frequency of valuation, collateral exchange and portfolio reconciliation the better so long as an optimal point is discovered over time with respect to process. Once the operational capacity to reconcile portfolios is put in place, the market will naturally gravitate to any optimal frequency. (Indeed, a higher reconciliation velocity may become a differentiating factor for dealers with their clients and therefore there will be commercial pressure – again – for dealers to step up their capacities.)The efficacy of valuation is dependent upon the frequency of trading of the underlying. Obviously, beyond modelling prices, there is little point revaluing a product daily if price points may only be discovered on a monthly basis. (And of course this would render setting clearing house margins based on infrequent real pricing as foolhardy.)

Given the conditional nature of many of the questions in the consultation, we think it may be useful for the Commission to differentiate between incentives and penalties. Whilst the Capital Requirements Directive ("CRD") may be used as a tool to penalise non-compliant participants, we do not feel this should be used to apply penalties should counterparties decide that carrying trades onto a CCP is not desirable. If end users are entities not subject to the CRD, it is unclear to us how regulatory changes to the CRD would induce these users to want to enter into clearing.

Furthermore, with the costs of settling through a CCP as yet unfixed (and possibly quite onerous for some participants), it may be another unintended consequence that institutions choose not to hedge and mitigate known exposures simply due to the applied costs from regulators. Such outcomes would not be desirable.

Central data repository

9 Are there market segments for which a central data repository is not necessary or desirable?

10 Which regulatory requirements should central data repositories be subject to?

11 What information should be disclosed to the public?

We again note the implicit judgement call within the issues. Given that the end users (such as corporates, state debt offices, pension funds, insurance funds or local authorities) are acting on behalf of their clients who form the wider population - should they not be in the seat of decision? If so, then the market mechanism will function in an efficient way and resources will be allocated as appropriate with a minimum of addition legislation. We do, as above, continually advocate effective and adequate supervision but, cognizant of the laws of unintended consequences, WMBA/LEBA advocates as minimal level of legislation as practicable.

We note that the costs of a central data repository would have to be borne by end users (in this regard we note the spiralling costs to end users being imposed by the FSA for the development of the "SABRE II" transaction reporting system). Whether these users would gain utility and become economic beneficiaries, and whether any central depository would offer the economies of scale derived from global reach would need to be proven a priori. The fear, otherwise, is that market efficiencies would be compromised in order to build an ill-conceived folly propelling the markets away from utilitarian, regulated and transparent venues.

Many financial institutions, not only banks who have committed significant funds to these projects, already use Central Data Repositories such as "TriOptima". Therefore, WMBA/LEBA would consider this issue largely non- contentious. We agree with ISDA that it remains the end user and sovereign sectors that now need encouragement.

Whilst a central data repository may provide supra-regional regulators with a useful tool to view completed OTC transactions it is unclear how it could belie the risk management of a firm which may have hedges to many underlying positions. We believe that the strong and beneficial operation of national supervisors who can access all the risk of an entity is of paramount importance. It is not clear that such

a repository would aid that function, and we would ask for further clarity between the objectives and requirements for central data repositories as opposed to CCPs.

Public disclosure needs to be separated from disclosure to regulators. Position level data of end users is private information and if disclosed to the public would compromise both the clients and shareholders of such institutions alike. We note that the imposition of the TRACE disclosures in the US at the start of the decade produced a distorted playing field that penalised providers of liquidity in the corporate bond market and incentivised end users to trade CDS product as a surrogate.

Conversely, we again note that the aggregated end of day product flows across the IDBs could be of timely value to regulators and may be provided by WMBA/LEBA.

Given the granular nature of OTC markets it is uncertain exactly which specifics of matching and volume information are of more relevance, but benchmark indications would appear the most useful and trades of this type are all currently reported to the relevant quote vendors in a timely manner (often instantaneously) by automated electronic means. A wide range of live and indicative price data is currently delivered by the IDBs to our clients and the wider community – some for active clients only and some under reasonable commercial terms to all – and heretofore their has been virtually no calls from members of the public to receive trading data directly from the IDBs. Should this be the case, or should the Commission wish for the IDBs to widen the delivery scope of data provision, WMBA/LEBA are prepared to participate in that conversation.

CCP Clearing

12 DO YOU AGREE THAT THE ELIGIBILITY OF CONTRACTS SHOULD BE LEFT TO CCPS?

- ***WHICH GOVERNANCE ARRANGEMENTS MIGHT BE NECESSARY FOR THIS DECISION TO BE LEFT TO THE CCPS' RISK COMMITTEES?***

13 WHAT ADDITIONAL BENEFITS SHOULD THE CCP PROVIDE TO SECURE A BROADER USE OF ITS SERVICES?

14 IS THE ZERO-RISK WEIGHTING A SUFFICIENTLY EFFECTIVE INCENTIVE FOR USING CCPS ACROSS DIFFERENT MARKET SEGMENTS?

15 SHOULD ADDITIONAL REQUIREMENTS, SUCH AS APPROPRIATE ACCOUNT SEGREGATION, BE INTRODUCED TO APPLY THE ZERO-RISK WEIGHTING TO INDIRECT PARTICIPANTS?

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16 SHOULD BILATERAL CLEARING OF CCP-ELIGIBLE CDS BE PENALISED AND, IF SO, TO WHAT EXTENT?

- ***IS THERE A NEED TO EXTEND REGULATORY INCENTIVES TO CLEAR THROUGH A CCP TO OTHER DERIVATIVES PRODUCTS?***

17 UNDER WHICH CONDITIONS SHOULD EXEMPTIONS BE GRANTED AND BY WHOM?

18 WHAT IS THE MINIMUM ACCEPTABLE RATIO OF CCP CLEARED/ELIGIBLE CONTRACT?

- ***WHAT IS THE MAXIMUM ACCEPTABLE NUMBER OF NON-ELIGIBLE CONTRACTS?***

19 WHAT STATISTICS NEED TO BE PROVIDED TO REGULATORS TO MAKE SURE THEY HAVE ALL THE INFORMATION NECESSARY TO PERFORM THEIR DUTIES?

20 HOW COULD EUROPEAN LEGISLATION HELP ENSURING SAFETY, SOUNDNESS AND A LEVEL PLAYING FIELD BETWEEN CCPS?

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. If the clearing offering is attractive and brings efficiencies, the response of the market will be powerful, but the decision must rest with end users who have the final fiduciary responsibility.

WMBA/LEBA refers back to the difficulties described on pages six and seven that arise in general with the term “Standardised” and therefore of the stance currently taken by the US authorities that if a trade is accepted by a single CCP then it should be deemed standardised and clearable. We restate our view that the efficacy of clearing is determined by the ability of an individual CCP to set timely and valid initial and variation margins, and that such an imposed top- down approach invites problematic clearing and compromises end users. Client choice remains paramount and prudential.

WMBA/LEBA maintains the position of targeting the optimum interoperability between CCPs such that the utility function for end users and their commitment of margin capital may be maximised. This should be facilitated by the General Clearing Members (“GCMs”) extending client margin across CCPs.

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. We note the aggregation and

concentration of risk involved in this process accretes to the GCMs of the CCP. We therefore further agree that the supervisory committees, CESR, CEBS and CEIOPS should be integrated closely with the Risk Committees and the CCPs themselves.

We note the differences in business models between CCPs with GCMs and those with Direct Clearing Members ("DCMs"), as well as the varying methods to incentivise such clearing members with equity stakes. Such organisation remains the prudent responsibility of the CCP however. WMBA/LEBA further advocates the continuing work done by ESCB and CESR and their recommendation for CCPs to provide robust frameworks. The progression towards a global revision by CPSS/IOSCO means that it remains prudent to allow more time for this process.

The use of a CCP will come with attendant costs in margin, money transfer, deal processing, audit and regulation. None of these come cheaply and will likely need to be replicated across a plethora of CCP options. It may be, then, that even a zero-risk weighting may not be a sufficiently effective incentive for a client to access a CCP, and that this 'design flaw' may well vary across different market segments. We believe that such issues are a matter for the marketplace to decide with the caveat that end users need to be given suitable choice of CCPs to avoid concentration risk and to ensure that a single entity does not gain a monopolistically advantageous position.

Surely, the segregation of client accounts from 'house' accounts is ultimately the commercial choice of the clearing members whose capital forms the clearing house. It is obvious there is long-term benefit for the net positions of each individual account to be visible on a per entity basis to regulatory and supervisory bodies. (This facility would have served as an early warning system to the build-up of end users derivative positions in 2006, 2007 and 2008.) However, as it is the GCMs capital that is at risk, the operation of segregated accounts, which will involve an entirely new manner of managing collateral and margin deposits, much be economically viable for each GCM. As such, we recommend once again that these matters need to remain in control of the Risk Committees.

The concerns of WMBA/LEBA revolve around the fungibility of OTC contracts against listed contracts which is an indicator of open and fair access to clearing. This may be aided by the interoperability of CCPs which directly benefits end users by optimising the deployment of their initial margins. In this way segregated, entity related accounts could be interoperable between clearing houses without breaking down internal buckets of margin. The bottom line, however remains, that it is the end user who needs to be given efficiencies and the CCP and it's clearing members who must be responsible for the risks.

From the above it follows that end users may have individual reasons not to clear CCP-eligible CDS or other OTC products. Such end users as regulated entities will

manage their risks with the national supervisors in accordance with the Basle II and the CRD. There is no need to penalize these entities fiscally, on top of and outside the CRD, since it is the task of the national supervisor to ensure they are acting in the interests of their clients and shareholders. Further penalties at a regional level may well engender unintended consequences such as driving transactions beyond regional boundaries and away from the interests of all stakeholders.

It further follows that should any exemptions be required from time to time or whether there should be any ratio, minimum or maximum metric of eligible cleared to non-cleared contracts then this is the responsibility of the national supervisors on a case by case basis. Again, the determinate of what is 'clearable' is a function of the ability of GCMs to introduce, capture, monitor and maintain margin protection against positions on their books and not an external definition or proposed ratio of what should be cleared as levied by outside agencies.

In terms of statistics, WMBA/LEBA can affirm that the IDBs are well placed to give both the regional and national supervisors flow, price and volume information in an end-of-day aggregated format. This may be done across the entire spectrum of OTC products including cash products in addition to derivatives. As a testament to the electronic and automated nature of the IDB business models, we believe it is possible to deliver such data in a variety of formats shortly after any nominated end-of-day time point. As such, we emphasise the equivalence in transparency between the trading and flow of OTC products versus those that are exchange executed. It may be prudent for WMBA/LEBA to work with CESR to examine the potential for aggregated broker data to provide regulators with the further transparency they seek.

In order to ensure a degree of fair competition between CCPs, we applaud the progress made so far by ESCB and CESR, and hope the Commission may introduce legislation that produces equivalence in governance, interoperability, and systematic risk considerations across the offerings. Specifically, we aspire for equal and open access by all trade matching venues to clearing on a trade-date basis, both commercially and technologically, to ensure that non-exchange trading venues are not disadvantaged to any exchange that operates a CCP.

TRANSPARENCY REQUIREMENTS

21 SHOULD MIFID-TYPE PRE- AND POST-TRADE TRANSPARENCY RULES BE EXTENDED TO NON-EQUITIES PRODUCTS?

- ***ARE THERE OTHER MEANS TO ENSURE TRANSPARENCY?***

22 HOW SHOULD TRANSACTION REPORTING OF OTC DERIVATIVES TO COMPETENT AUTHORITIES BE ENVISAGED?

- ***SHOULD IT BE EXTENDED TO ALL CONTRACTS OR TO CERTAIN CATEGORIES?***
- ***IF SO, WHICH ONES?***
- ***ARE THERE OTHER MEANS TO ENSURE THAT THE COMPETENT AUTHORITIES RECEIVE THE RELEVANT INFORMATION ON OTC DERIVATIVES TRANSACTIONS?***

23 HOW SHOULD POSITION REPORTING OF DERIVATIVES TO COMPETENT AUTHORITIES BE ENVISAGED?

- ***SHOULD IT BE EXTENDED TO ALL CONTRACTS OR TO CERTAIN CATEGORIES?***
- ***IF SO, WHICH ONES?***
- ***ARE THERE OTHER MEANS TO ENSURE THAT THE COMPETENT AUTHORITIES RECEIVE THE RELEVANT INFORMATION ON THE EXPOSURES TO PARTICULAR CONTRACTS?***

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. We believe this would drive trading away from liquid platforms and decrease hedging altogether all to the ultimate cost of end users.

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 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, regulators and, if required, the general public alike.

The publication of either individual 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 hedging flows. IDBs are not in a position to either access nor publicise position level data which remain within the responsibilities of national supervisors.

Public trading venues

24 How can further trade flow be channelled through transparent and efficient trading venues?

- ***What would be the appropriate level of transparency (price, transaction, position) for the different derivatives markets?***

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.

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. We note, and cite the above evidence, that these facts are in direct contradiction to the Commission's statement that "*OTC derivatives have been at the centre of the crisis".* Conversely, OTC derivatives have been the heart of the solution.

Part 3: Annex

i. 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.

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(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.

ii. What is an inter-dealer broker?

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.

iii. 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:

- Enhancing price discovery and transparency
- Increasing pricing confidence
- Protecting clients' interests
- Providing anonymity and confidentiality
- Managing complex trades
- Facilitating information flow
- Facilitating enhanced liquidity
- Improving market efficiency
- Delivering multi-lateral electronic trading and settlement solutions
- 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.

Summary observations and recommendations

i. 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.

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ii. 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.

iii. 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.

iv. 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.

v. 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.

vi. 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.

vii. 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.

viii. 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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ix. 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.

x. 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.

i. WMBA/LEBA Membership

- BGC Partners
- EBS Group
- GFI Group Inc.
- ICAP plc
- Martin Brokers (UK) Ltd
- Reuters Transaction Services Ltd
- Sterling International Brokers Ltd
- Tradition (UK) Ltd
- Tullet Prebon Ltd
- APX Power UK
- CantorCO2e Ltd
- Evolution Markets Ltd.
- GFI Group, Inc
- ICAP Energy Ltd
- PVM Oil Associates Ltd
- Spectron Group Ltd
- Tradition Financial Services Ltd
- Tullet Prebon Energy Ltd