



CONSULTATION PAPER

**Standardisation and exchange
trading of OTC derivatives**

Deadline for contributions: CESR invites responses to this consultation paper by **16 August 2010**. All contributions should be submitted online via CESR's website under the heading 'Consultations' at www.cesr.eu. All contributions received will be published following the close of the consultation, unless the respondent requests its submission to be confidential.



Table of contents

Executive Summary

1. Introduction

2. A preliminary step on the way to exchange trading: Standardisation

2.1. Concept of 'standardisation'

2.2. Benefits and limitations of standardisation

2.3. Assessment of the degree of standardisation of OTC derivatives

2.5. Assessment of existing market-led and regulatory initiatives to promote standardisation

2.6. Preliminary conclusions

3. Exchange trading

3.1. Assessment of the degree of exchange trading of OTC derivatives

3.2. Benefits and limitations of exchange trading of standardised OTC derivatives

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

3.4. Concept of 'exchange trading' in the context of OTC derivatives

3.5. Assessment of existing market-led and regulatory initiatives promoting exchange trading

3.6. Preliminary conclusions: assessment and policy views on 'exchange trading'

4. Conclusion and next steps

Annex I: Summary of consultation questions



Executive Summary

Following the financial market turmoil which began in 2007, a number of regulatory initiatives have been launched to address the problems identified in Europe and the United States in relation to the derivatives traded over-the-counter (OTC).

In this regard, the Commission's communication "Ensuring efficient, safe and sound derivatives markets: Future policy actions" [COM (2009) 332 final] states – among others - that consideration should be given to ensuring that trades eligible for exchange trading take place on organised trading venues as defined by MiFID. In the U.S., legislative initiatives have been launched in the House of Representatives and the Senate following the Administration's initiative to strengthen OTC derivative markets through improving risk management and increasing transparency.

In this paper CESR explores the need for taking regulatory actions in relation to further standardisation for credit, equity, interest rate, commodity and foreign exchange derivatives both as a means in itself and also in relation to the promotion of trading of these derivatives on organised markets. This paper does not analyse issues related to post-trading and in particular eligibility for clearing.

In relation to **standardisation**, CESR is of the opinion that firms should be able to retain the flexibility to customise aspects such as standard valuation, payment structures and payment dates given the role that OTC derivatives, and in particular bespoke products, play in meeting hedging needs. Nevertheless, CESR is of the view that greater standardisation of OTC derivatives contracts can deliver efficiency benefits to the market. In particular, CESR has identified the use of electronic confirmation systems as one measure which could potentially deliver benefits to the market.

To date, much of this work has been industry-driven but the question now faced by regulators is whether current progress is sufficient, how best to build on current industry initiatives, and whether regulatory intervention is needed.

As a consequence, CESR is eager to explore with the industry what measures could be taken to foster a higher degree of standardisation. As the degree of standardisation differs by asset class, CESR is keen to solicit views on whether regulators should prioritise their focus on a) a certain element of standardisation and/or b) a particular asset class. CESR particularly invites market participants to provide information on the potential costs of introducing a mandatory electronic trade confirmation requirement for European trading of OTC derivatives so that CESR can take an informed decision when making its final recommendations to the European Commission.

In relation to '**exchange trading**' of derivatives currently traded OTC, CESR believes that trading on organised markets could deliver a number of benefits like providing a higher level of transparency, enhancing liquidity, ensuring efficiency and risk reduction and providing an easy access for market participants. There are however also a number of limitations or pre-requisites to exchange trading of derivatives that may explain why the OTC segment of the market remains very large: the need for the contracts to be standardised, the inability to customise contracts according to individual customers' needs and the limited possibility for products innovation. As a preliminary opinion, CESR is in favour of incentivising the use of organised trading venues but continues to consider whether mandatory usage is desirable, taking into account the discussions currently taking place on this issue in other jurisdictions and international fora. Therefore, CESR would like to further explore with market participants which kind of incentives could effectively promote exchange trading.



1. Introduction

1. The financial markets turmoil that started in June 2007 has revealed shortcomings in the management of counterparty credit risk and an absence of sufficient transparency in OTC derivative markets. In order to improve resilience of OTC derivative markets going forward, at its meeting of 25 September 2009 the G20 called for the strengthening of OTC derivatives markets stating that "all standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate".
2. In the U.S. legislation has been proposed to strengthen the safety of derivative markets through standardisation, central clearing and exchange trading. Legislation has been initiated both in the House of Representatives and the Senate based on plans tabled by the U.S. Treasury¹.
3. In Europe, the European Commission has outlined in its Communication "Ensuring efficient, safe and sound derivatives markets: Future policy actions" [COM (2009) 563 final] the core lines of the policy actions it intends to take in 2010 to address these problems². The Commission states that in line with the G20 declaration, consideration should be given to ensuring that eligible trades for exchange trading take place on organised trading venues, as defined by MiFID. It also foreshadows joint work with the industry to increase the degree of standardisation of legal regimes and processes.
4. CESR has decided to look into these matters and as a first step to publish a consultation paper on the standardisation and exchange trading of OTC derivatives, in particular credit, equity, interest rate, commodity and foreign exchange derivatives. CESR intends to finalise its position after taking into account the reactions to this consultation paper and to send a technical advice to the European Commission in September. During the consultation period, an open hearing will be organised for interested stakeholders. CESR's final position will reflect the outcome of both the consultation and the open hearing and, where appropriate, contacts with relevant industry groups which are also considering this issue. The final advice and a feedback statement will be published on CESR's website.
5. It is relevant to highlight that despite the evident links between the concepts of standardisation, exchange trading and eligibility for clearing, this consultation paper focuses solely on the first two aspects. CESR's work regarding eligibility for clearing is carried out in the context of the preparation of the future European Market Infrastructure Legislation.
6. This consultation paper is organised as follows. Section 2 describes issues concerning standardisation as a preliminary step on the way to exchange trading but also includes thoughts on the value of standardisation as such. This section introduces the concept of standardisation, describes the benefits of standardisation and the limitations for further standardisation, assesses the current degree of standardisation of OTC derivatives contracts and also explores existing market-led and regulatory initiatives to promote standardisation. Section 3 considers exchange trading of OTC derivatives. It includes an assessment of the current degree of exchange trading of OTC derivatives, a part exploring the benefits and drawbacks of exchange trading of standardised OTC derivatives, consideration on the characteristics and the level of standardisation necessary for the eligibility for exchange trading, an analysis of the concept of 'trading on organised markets' in the EU legislative

¹ Please note that the Dodd-Frank Wall Street Reform and Consumer Protection Act and the Restoring American Financial Stability Act were passed by the Senate of the United States on 15 July and, at the time of finalising this paper, they are pending the U.S. President's signature to become law. Further details of the U.S. initiatives are discussed in Sections 2.5 and 3.5.

² Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, the Committee of the Regions and the European Central Bank, *Ensuring efficient, safe and sound derivatives markets: Future policy actions*, 20.10.2009 [COM (2009) 563 final].



context and an assessment of existing market-led and regulatory initiatives promoting exchange trading of OTC derivatives. Finally, the report summarises in Section 4 the policy proposals and recommendations and outlines the proposed next steps in the development of CESR's advice to the European Commission. Annex I provides a summary of the consultation questions for ease of reference.

Market structure³

7. Derivatives are financial contracts whose value (price) is derived from the value of an underlying asset (e.g. equity, bond or commodity) or market variable (e.g. interest rate, credit risk, exchange rate or stock index). They can be classified into four categories: futures (and forwards), options, swaps and exotic instruments.
8. A derivatives transaction may be set up for one of four different reasons: hedging, funding, speculation and arbitrage. Despite the increasing amount of exchange trading, a significant amount of derivatives are currently bilateral, privately negotiated contracts that can be settled in cash or physically, tailored to meet specific needs of the involved counterparties.
9. Accordingly, the market for derivatives is primarily a wholesale market (although it includes a wide range of participants), with the exception of the market for equity derivatives where retail investors trade futures and other exchange traded derivatives. Due to these specific features, derivatives are typically traded over-the-counter (OTC), i.e. directly between two parties without intermediation of an exchange or other intermediary. However, there is also an increasing number of derivatives traded on regulated markets, MTFs or on single-dealer electronic trading platforms.
10. Interest rate derivatives accounted for by far the largest share of OTC derivatives, about 73% of the notional amount of outstanding OTC derivatives at the end of December 2009. Foreign exchange contracts and credit default swaps followed with about 8% and 5% respectively. The relative share of equity linked contracts and commodity contracts is much smaller with just above 1% and 0.5% respectively.⁴ However, as a general remark it is important to highlight that the differences between markets (and in particular, between markets within the commodities space) may be relevant.

Market size

11. The market for OTC derivatives showed an impressive rate of growth in the last decade, reaching its peak in mid-2008 with more than USD 680 trillion of gross notional value for outstanding contracts⁵. The OTC derivatives market grew between June 2001 and June 2008 by circa 535% at the annual weighted average rate of 33.68%. As an immediate result of the financial crisis and the reduced activity of financial institutions, the notional value dropped by 20% to around USD 547 trillion in the second half of 2008. In the first half of 2009 the market grew again by about 10% to USD 605 trillion, increasing modestly by 2% to USD 615 trillion in the second half of 2009.
12. According to the BIS-data provided per asset class, the notional amount outstanding at the end of December 2009 of OTC interest rate derivatives was USD 450 trillion, foreign exchange derivatives USD 49 trillion, equity derivatives USD 6.6 trillion, commodity derivatives USD 2.9 trillion and credit default swaps USD 33 trillion. At the same date, the notional amount outstanding of exchange traded contracts was USD 73.1 trillion (USD 63.3 trillion at the end of June 2009). Note that it was USD 79 trillion at the end of 2007, USD 82 trillion by June

³ The paragraphs on market structure and market size rely on the recent ECMI Research Report (No.5/April 2010) by Diego Valiante and the BIS reports on the OTC derivatives market activity in the first half of 2009 (November 2009) and the second half of 2009 (May 2010).

⁴ Based on data from BIS, OTC derivatives market activity in the second half of 2009, May 2010.

⁵ Gross nominal or notional value of all deals concluded and not yet settled on the reporting date.



2008 and USD 57.9 by December 2008, so the notional amount of outstanding exchange-traded contracts was significantly higher at its peak.⁶

2. A PRELIMINARY STEP ON THE WAY TO EXCHANGE TRADING: STANDARDISATION

2.1. Concept of standardisation

13. There are three elements to be considered in relation to standardisation⁷:

- a. Legal uniformity: this includes standard transaction documentation and definitions;
- b. Process uniformity (automation): this includes straight-through-processing matching, confirmation, settlement and event handling;
- c. Product uniformity: including standard valuation, payment structures and dates.

14. There is a strong inter-linkage between each of these with legal uniformity as the driver to achieving other elements of standardisation.

a. *Legal uniformity/contract uniformity*

15. Legal/contract uniformity encompasses the standard legal relationships, confirmation agreements, documentation and market conventions in event handling⁸. In principle, OTC derivatives transactions are subject only to the rules devised by the parties or set by applicable and overriding law. Consequently, an agreement reflecting the negotiations between the parties is a necessary feature of the OTC derivatives markets. The agreement sets forth the particular economic terms of each tailored transaction, as well as the legal protections the parties wish to put into place.

16. There has been a significant evolution from the early days of the OTC derivatives markets (where each transaction was documented in 'ad hoc' comprehensive agreements) to the current situation, where standardisation of terms and documents is understood as a way to improve efficiency.

17. Typically, contracting parties put in place a master agreement which governs the legal terms of their relationship and all transactions they have done or will do between them. There have been several different standard legal agreements used for this purpose in the past⁹. Nowadays, the most widely used standard legal agreement is the ISDA Master Agreement and associated documentation. These documents serve to enhance legal certainty and risk management (through its underpinning of netting and collateral) against bilateral counterparty risk. The documentation of the financial and economic terms of each transaction is described below.

⁶ Other calculations by Deutsche Börse and ECMI estimating the notional amount outstanding for exchanges traded derivatives to be around 10% of the global derivatives market roughly support these figures.

⁷ Norman Menachem Feder, *Deconstructing Over-the-Counter Derivatives*, 2002, Columbia Business Law Review 677, 2002. ⁸ See summary of the Commission Consultation on 'possible initiatives to enhance the resilience of OTC Derivatives Markets', available at http://ec.europa.eu/internal_market/consultations/docs/2009/derivatives/derivatives_consultation.pdf.

⁹ Some of the most commonly used agreements were those of British Bankers' Association (BBA), Association Française des Banques (AFB) or FXNET Ltd. However, nowadays, the most important one is the International Swaps and Derivatives Association, Inc. (ISDA).



18. The law governing the relationship between the transacting parties will determine any legal issue not properly addressed in the documentation. Other laws may also be relevant, including the insolvency law of the jurisdiction in which an insolvent counterparty may be established.

Standard definitions and contract terms

19. In common with all financial contracts, OTC derivatives are documented via contracts which employ definitions. In most OTC derivative markets, standardised definitions are published by ISDA and these are included by reference within the documentation. Standard definitions allow firms to use readily understood building blocks to design contracts which may demonstrate a range of complexity. They are often drafted using a “menu” approach so that a number of different variations and options (e.g. interest rates for interest rate swaps or unexpected life cycle events relating to shares for equity swaps) are available for use by parties for any particular transaction.
20. Published alongside definitions are forms of confirmation for each product type covered. Parties would then agree a few key economic terms at the time of trading and add them to the applicable confirmation form to produce the documentation for the transaction. A standard contract would usually use standardised definitions.
21. For more complex transactions, e.g. credit derivatives, parties use “master confirmation agreements” which establish the accepted terms for a particular product between the two parties. The economic terms of any particular transaction are then agreed via a short supplement at the time of trading.
22. Some transactions use various, proprietary contract terms, either because there are no applicable standard contract definitions and terms available or at their choice for other reasons. Most transactions would use those definitions and terms if they documented deals of the product type covered.

b. Process uniformity/automation (of post-trade processes)

Electronic trade confirmations

23. Processing of negotiated OTC derivative contracts may be facilitated by the use of automated electronic procedures such as automatic generation and matching of trade confirmation in electronic platforms. Once the parties to the transaction have defined and agreed the terms and conditions (i.e. executed a trade), the details of the transaction can be captured, verified and confirmed in electronic platforms. This has the benefit to avoid uncertainty and to reduce the risk of unconfirmed trades. The use of automated systems ensures that details of trades are agreed early and accurately captured. Automation is key for achieving straight-through-processing (STP). Moreover it facilitates settlement processes and can be used in both high and low velocity markets. However, a high degree of standardisation is needed in order to facilitate electronic trade confirmations.
24. The degree of electronic processing of confirmations varies among the various classes of derivatives. Credit derivatives show the highest degree (97%) of confirmations eligible for electronic matching and actually matched electronically (92%). Equity derivatives show the lowest degree of eligibility (40%) with even less contracts eventually confirmed (23%).

Table: Electronic confirmation¹⁰

	Credit	Currency	Interest	Commodities ¹¹	Equity
--	--------	----------	----------	---------------------------	--------

¹⁰ Source: ISDA 2009 Operation Benchmarking Survey.

¹¹ Please note that the differences between markets (and in particular, between markets within the commodities space) may be relevant.



Electronically confirmed	92%	51%	48%	46%	23%
Eligible but not electronically confirmed	5%	19%	30%	35%	17%
Not eligible	3%	30%	22%	19%	60%

25. In line with the high level 'Recommendations for securities settlement systems' made by the Committee on Payment and Settlement Systems and IOSCO in 2001¹², CESR and ESCB published their joint 'Recommendations for securities settlement systems and recommendations for central counterparties in the European Union' in May 2009 where again it was encouraged that confirmation of trades between direct market participants should occur as soon as possible after trade execution, but no later than (the end of) the trade date (T+0)¹³. Where confirmation of trades by indirect market participants (such as institutional investors) is required, it should occur as soon as possible after trade execution, preferably on T+0, but no later than T+1. For those purposes, fully automated and fully interoperable systems should be in place, to avoid inefficiency and market fragmentation.
26. During 2009 the monthly average of business days for outstanding confirmations was roughly 5.5 to 6 days for all OTC derivatives, while in 2008 it was more or less 9 days. In principle, it implies that a relevant percentage of the market still uses non-automated systems (e.g. verbal confirmation)¹⁴ but nevertheless good progress is being made in this area.
27. In the letter sent by the G14 to the Federal Reserve of New York and in the framework of the commitments made by the industry to global supervisors, one of the key topics under consideration is to build on operation performance, with a focus on driving 'electronification', straight-through-processing, trade matching, affirmation and processing. In that context, significant and measurable commitments are reported in relation to equity derivatives¹⁵ and interest rate derivatives¹⁶ (see also Section 2.5).
28. The three U.S. regulatory initiatives currently under way ('OTC Derivatives Market Act', 'Restoring American Financial Stability Act' and 'Derivative Markets Transparency and Accountability Act') foresee that products required to be cleared must also be executed on an exchange or an alternative swap execution facility (ASEF), which include certain electronic trade execution and voice brokerage facilities¹⁷.

Straight-Through Processing (STP)

29. Trade-capture via electronic systems (even if this occurs post trade) allows STP to market participants' internal risk management and settlement systems. STP can be defined as a mechanism that automates the end-to-end processing of transactions of the financial instruments. It involves use of a single system to process or control all elements of the workflow of a financial transaction, including what is commonly known as the Front, Middle, and Back office, and General Ledger. In other words, STP can be defined as electronically

¹² <http://www.bis.org/publ/cpss46.pdf>

¹³ http://www.ecb.int/press/pr/date/2009/html/pr090623_escb-cesr_recommendations.pdf?3e2c37573d0f581291187bdd72468c52

¹⁴ See Valiante, op. cit., quoting ISDA sources.

¹⁵ Publication of an Electronic Eligibility Matrix of Electronically Eligible Products and Confirmable Lifecycle Events that should be periodically updated. By 30 June 2010, 75% of Electronically Eligible Confirmations on an electronic platform to be increased to 80% in September 2010.

¹⁶ By 30 June 2010, 93% of electronically eligible confirmable events with G14 members will be processed on electronic platforms, to be increased to 95% in the end of the year. For the rest of the industry the commitment is to reach 60% by 30 June 2010.

¹⁷ See for further information on this: Deutsche Bank Research. *OTC Derivatives. A new market structure is taking shape*. April 28, 2010, available at http://www.dbresearch.de/PROD/DBR_INTERNET_EN-PROD/PROD000000000256894.pdf. Please note that the Dodd-Frank Wall Street Reform and Consumer Protection Act and the Restoring American Financial Stability Act were passed by the Senate of the United States on 15 July and, at the time of finalising this paper, they are pending the U.S. President's signature to become law.



capturing and processing transactions in one pass, from the point of first 'deal' to final settlement¹⁸. In order to achieve STP all the elements of standardisation mentioned above need to be achieved.

c. Product uniformity

30. Whilst definitions and contract terms can be standardised, they can allow for a certain degree of flexibility around some aspects of the contract such as payment dates, coupons and life cycle events. Parties can then use that flexibility to build their transactions according to their needs. Contracts that exhibit such flexibility can be regarded as non-standardised. One of the reasons for the large growth of the OTC derivatives business over the last 25 years or so was the flexibility it allowed parties to structure their transactions.
31. As markets grow or mature, an increasing number of trades tend to be highly similar and naturally conventions (i.e. standardisation) appear which increase the level of standardisation of the product. However, even in a market where those conventions are used for many transactions, parties may choose not to use them for other transactions so that they can construct bespoke deals for a particular situation.
32. Product standardisation influences the economic profile of a contract through amending features like standard valuations, payment structures, size, maturity, termination, asset class, delivery date or delivery location¹⁹. The so called menu of choices provided by the definitions is whittled down to one particular version which is commonly used for a particular product type. Aside from highly standardised derivatives (e.g. benchmark CDS index products), OTC derivatives are tailored particularly to permit parties to enter into transactions in order to hedge the risk of relatively unique underlying and structure transactions with relatively unique terms and conditions (such as settlement dates and amounts, maturities, strike prices and so forth) to match their risk profile.

Preliminary conclusions

33. CESR recognises that legal and contract uniformity is the driver to achieving other elements of standardisation. As noted in Section 2.3 below, there appears to be widespread adoption of standard legal definitions and documents in the market. Nevertheless CESR is keen to understand whether more needs to be done in this area, especially with a view to achieving other elements of standardisation.
34. CESR also recognises that bespoke OTC derivatives are often used for hedging purposes by non-financial firms and as a result CESR is of the view that firms should be able to retain the flexibility to customise aspects such as standard valuation, payment structures, payment dates, and so forth for OTC derivative transactions. However, this needs to be carefully balanced against the benefits that adoption of straight-through processing and other automated confirmation systems can deliver. CESR is therefore eager to explore what measures could be taken to foster a higher degree of product standardisation based on the firm belief that a wider use of electronic post-trade processes would enhance the resilience of the market.
35. CESR acknowledges the significant progresses made by the industry towards an intensified use of electronic confirmation systems, but considers that there is – depending on the asset class - significant room for further improvement in this area. CESR is therefore considering to recommend to the European Commission to take regulatory action so as to make the use of electronic confirmation systems mandatory and seeks to explore as part of this consultation

¹⁸ <http://www.sebi.gov.in/faq/faqstp.html>

¹⁹ <http://gfsnews.com/article.php?id=13>



process what scope this should take and which instruments in particular should be the focus of regulatory attention.

36. As part of this assessment CESR is considering the most appropriate way a mandatory requirement might be applied. In doing so CESR will consider the cost implications for all participants and in particular for smaller participants.
37. Electronic confirmation systems provide legal certainty to the parties of the trade. This can provide benefits across the market, but from a systemic risk perspective benefits will be larger when adopted by participants who have the potential to pose a risk to the financial system - either in isolation or in aggregate. With these factors in mind a 100% mandatory requirement may not be necessary in order to achieve the desired regulatory goal.

2.2. Benefits and limitations of standardisation

38. There currently exists a spectrum of standardisation across all OTC derivative asset classes. This ranges from the highly standardised, fungible products to entirely bespoke transactions. Volumes are typically higher for standardised products where liquidity is greatest whereas volumes tend to be lower for the most bespoke transactions.

2.2.1. The benefits of increased standardisation

39. As outlined below standardisation can facilitate improved risk management processes and enhance the usefulness of pre and post-trade information. It should be noted that not all of the benefits noted below require complete fungibility of products (i.e. the ability to fully substitute one contract for another). Some are satisfied by a lesser degree of standardisation

Risk management benefits

- 1) **Operational risk reduction** – Non-standardised products can (though not always) require bespoke operational processes and life-cycle processing. For a small population of trades, such processes would be less likely to be automated and instead require manual intervention which can increase operational risk. Due to economies of scale, standardised products lend themselves to higher degrees of automation and consequently reduce operational risk. In line with that, in many financial markets it is common to use the advantage of electronic portfolio management in one single system, even if the system is operated by several different market specialists. It allows multi-product trading whereby all the products in the portfolio are seen as just one single risk position, but it makes difficult to assess independently one of the elements of the position. To manage that difficulty, risk calculation permits to calculate reliable correlations between all the products. Therefore, product standardisation might facilitate an appropriate calculation of correlations.
- 2) **Facilitates the use of clearing** – The operations and risk management of a clearing house are simplified when all the contracts under management exhibit fungible terms and therefore can be grouped together though some small bespoke aspects can be managed at an operational cost.
- 3) **Facilitates the use of electronic trading venues** – In order for a product to be eligible for trading on automated systems, there needs to be a high degree of product standardisation and a limited requirement to negotiate price.
- 4) **Ease of unwind** – A fungible product can be used to perfectly offset or value the acquired risk. This can improve efficiency when positions need to be offset or terminated for risk purposes. Standardised products are also easier to model, understand and stress test with certainty.



- 5) **Facilitates the reporting of information for regulatory purposes** – The use of standardised reporting fields (as a result of standardised products) eases the reporting of information. This is more difficult to achieve for bespoke products.
- 6) **Enhances contractual certainty** – The greater use of standard definitions and contract terms enhances the degree of contract certainty. This can be particularly useful in times of dispute between counter-parties.

Other benefits:

- 1) **Transparency based on standardisation increases pricing comparability** – Standardisation is a pre-requisite to meaningful pre- and post-trade transparency. The ability to draw conclusions from the data available as to the relevant price of a homogeneous alternative product is more likely to be possible if there is a high degree of standardisation across the product type in question.
- 2) **In the context of market monitoring, standardisation improves information sharing (particularly for regulators)** – It is currently difficult to apply universally understood classification to some OTC derivative products and the inability for parties to share information on universally understood basis can lead to inefficiencies in market monitoring and regulatory co-ordination. This may be improved by enhanced standardisation.
- 3) **Improves the meaningfulness of information (of positions from a trade repository)** – Trade repositories currently have two objectives in relation to the provision of information. In the first instance they provide information to regulators on the positions of supervised firms for financial stability purposes. In the second instance they can provide aggregate trade information to market participants for price formation purposes. It is in meeting both objectives that greater standardisation is particularly beneficial as the use of standardised products facilitates standardised reporting which ultimately enables a trade repository to more easily aggregate information.

2.2.2. The possible limitations to standardisation

40. Financial and non-financial institutions are both active users of OTC derivatives. Preserving the ability of non-financial institutions to use OTC derivatives to hedge their risks is an important consideration in the standardisation debate.
 1. **Legitimate need for bespoke products:** Financial and non-financial institutions are both active users of OTC derivatives. The drive towards greater standardisation should be balanced with the need to preserve the ability of non-financial institutions to use OTC derivatives to hedge their risks. For example in some instances market participants need access to variable rather than standard transaction sizes; in commodity markets the wide variety of underlying products and supply and delivery locations can limit the usefulness of standardisation.
 2. **Exposure to basis risk:** The use of standardised products may limit the ability of market participants to perfectly hedge their risk profile. In some instances this may result in the firm being exposed to basis risk which it is impossible to hedge.
 3. **Loss of hedge accounting benefits.** The use of standardised products to hedge exposures may result in an imperfect match between the underlying and the hedge position. In such instances market participants will lose beneficial hedge accounting treatment under rule IAS

39²⁰. This issue was raised by some respondents to the Commission’s consultation on “Possible initiatives to enhance the resilience of OTC Derivatives Markets”²¹.

4. **Product maturation:** A sufficient degree of product maturation is needed in order to support drives towards greater standardisation.

2.3. Assessment of the degree of standardisation of OTC derivatives

41. The degree of standardisation, in terms of supporting legal documentation, contract specifications and the use of automated trade processing, varies considerably across OTC derivative asset classes. The table below summarises some of the key features of these markets and offers a high-level assessment of the degree of standardisation currently available in the market informed by discussion with market participants.

OTC derivative asset class	CREDIT	INTEREST RATES	EQUITY	COMMODITY ²²	FX
Market participants	High inter-dealer concentration	Very diverse – dealers dominate but activity from buy-side and corporates	Financial buy and sell-side firms and some corporates	Broad range of financial and non-financial firms.	Broad range of financial and non-financial firms.
Standard definitions	Yes (ISDA) (and widely used)	Yes (ISDA) (and widely used but less than credit)	Yes (ISDA) Work in progress – plans for radical update this year	Yes (ISDA, EFET, NAESB and others)	Yes (ISDA and others)
Availability of Master Confirmation Agreement	Yes (and widely used)	No*	Partial (current focus of Regulator/industry forum)	Yes - Multiple – tied to master documentation agreements (see above)	Yes (and widely used)
Standard trading terms	Yes (and widely used)	Yes – benchmarks in dealer to dealer (D2D) and both benchmarks and off-benchmarks in dealer to client (D2C)	No	Yes - Extensive and diverse given broad range of products	Yes
Electronic post-execution confirmation service	Yes (and widely used)	Yes (Close to 100% for D2D and increasing D2C)	Standardised products only and limited to inter-dealer and large buy-side	Yes - multiple offerings and significant take-up. Accelerating take-up in non-	Yes (and widely used)

²⁰ Note though, however, that there are legitimate reasons why firms engaging in hedging activity may not qualify for hedge accounting treatment under IAS39.

²¹ http://ec.europa.eu/internal_market/consultations/docs/2009/derivatives/summaryderivcons_en.pdf

²² Please note that the differences between markets (and in particular, between markets within the commodities space) may be relevant.

		penetration)		dealer community as well.	
Standard life cycle events	Yes	Yes (for rate setting, unwinds and novations)	No (area of exploration by the industry)	Yes – varies among diverse products	Yes
High volume	Indices	Swaps, forwards, cross-currency swaps, options.	Portfolio swaps, options	Swaps, options	Forwards, options
Good Liquidity	Indices and some single names	Swaps, FRAs, cross-currency swaps, options	Portfolio swaps, options	Forwards, swaps, options	Forwards
Current availability of CCP clearing	European indices and liquid constituent single names	Interest rate swaps, overnight indexed swaps, forward rate agreements, caps, floors	European and non-European options, futures and indexes	Significant cleared OTC capabilities and take-up across a wide range of offerings (NYMEX, ClearPort, ICE, others)	Limited
Electronic trading	Inter-dealer transactions via IDB (in Europe), dealer to client more likely via voice	Voice dominates but very broad range of on and off-benchmark rates products	No	Voice dominates but number of broker e-trading platforms as well as ICE.	Some
Assessment of degree of standardisation	High	Reasonable	Limited	Reasonable	Reasonable

*Note that the absence of Master Confirmation Agreements has not limited the use of electronic confirmation processes for interest rate derivatives

42. It would appear that credit derivatives are the most standardised asset class. This is in terms of use of the standardised legal documentation, standardised contract terms and the wide adoption in the inter-dealer market of electronic trade confirmation systems. Much of this has directly arisen as a result of industry initiatives in this area (see Section 2.5 for further information).

43. The interest rate derivative market has a more diverse range of market participants but nevertheless exhibits a good degree of overall standardisation. This is reflected in the use of CCP clearing and electronic trading platforms by some market participants. Whilst the degree of electronic post-execution confirmation usage is high in the dealer-to-dealer market, there appears to be scope for wider adoption in the dealer- to-client market.



44. OTC equity derivatives appear to be at the other end of the standardised spectrum. This might be explained by widespread usage of exchange trading for some equity derivatives. As a result those transactions which do take place OTC tend to be highly bespoke and therefore less easily captured by standardised legal documentation. Coupled with the smaller market share this may suggest that the benefits which can be delivered by developing automated processes are not proportionate to the cost of doing so.
45. Like interest rate derivatives both the FOREX and commodity derivative markets have widely adopted standard definitions and confirmation agreements. In addition there are also CCP clearing and electronic trading platforms in place, although for some segments voice execution continues to dominate. Overall the FOREX market can be considered to have a good degree of standardisation.

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

2.5. Assessment of existing market-led and regulatory initiatives to promote standardisation

46. In Europe, it is necessary to refer to the Commission's initiative to enhance the resilience of OTC derivatives markets. The Commission published a consultation document on 3 July 2009 (COM (2009) 332 final), where it consulted not only on the promotion of further standardisation and moving trading to public trading venues but also on connected issues such as strengthening bilateral collateral management for non-CCP eligible contracts, trade repositories, and the use of central counterparties for standardised OTC derivatives. As a result of this consultation, the Commission has published a summary of the responses received on 16 October 2009 and its Communication to the European Parliament, the Council, the European Economic and Social Committee, the Committee of the Regions and the European Central Bank on Ensuring efficient, safe and sound derivatives markets: future policy actions" (COM (2009) 563 final), where the following policy actions were tabled:
- a. In order to reduce operational risks, standardisation will be promoted by:
 - i. Assessing whether to re-shape the operational risk approach in the Capital Requirements Directive
 - ii. Working with the industry to increase standardisation of legal regimes and processes.
 - b. In order to increase transparency of trading, it is foreseen to:
 - i. Amend MiFID to require transaction and position reporting to be developed in conjunction with CCPs and trade repositories;
 - ii. Ensure trading of standardised contracts on organised trading venues under MiFID;
 - iii. Achieve trade and price transparency across venues and OTC markets, as appropriate, in MiFID; and
 - iv. Conclude the review of exemptions from MiFID for commodity firms.
47. In the U.S., industry representatives have been working since the summer of 2005 with the regulatory community to deliver improvements to OTC derivative markets. Initially these were largely operationally focused but in recent years, as focus on improving the resilience of OTC derivative markets has heightened so too has the scope of the commitments and the market participants involved. Although these represent commitments to the NY Federal Reserve Bank and other OTC derivative supervisors (such as the UK FSA, BaFin and the French Commission Bancaire), they are widely known as 'the industry Commitment letters'. These letters are publically available on the NY Fed website²³.

²³ <http://www.newyorkfed.org/newsevents/news/markets/2010/ma100301.html>



48. Of particular relevance to this consultation paper are the following commitments made in March 2010 which seek to build and improve upon previous commitments in this area:

- Driving a high level of product, processing and legal standardisation in each asset class with a goal of securing operational efficiency, mitigating operational risk and increasing the netting and clearing potential for appropriate products.
- Building on improvements in operational performance, with a focus on driving 'electronification', straight through-processing, and trade data matching/affirmation and processing

49. Specifically the March 2010 letter²⁴ commits to work with supervisors to evaluate the levels of standardisation and processing of credit, equity, and interest rate derivatives and to prioritise the areas which would benefit from greater standardisation. The initial phase of this work has been delivered and regulators are currently assessing the findings.

50. In terms of regulatory initiatives, at the global level the Financial Stability Board has established a working group to report by October on the policy options to increase the standardisation of OTC derivatives and to develop a clear process to implement consistently mandatory clearing and exchange or electronic trading requirements.

51. In the US the current administration has set out its plans for reform. In general it supports moves towards greater product standardisation and subsequent improved risk management (through the use of CCP clearing) and wider adoption of electronic trading platforms. The US legislative process is now underway with both the House of Representatives and the Senate working together to draw up implementing legislation²⁵.

2.6. Preliminary conclusions

52. Whilst recognising the role bespoke products can play, CESR is of the view that greater standardisation of OTC derivatives contracts can deliver efficiency benefits to the market.

53. It is clear that the current degree of standardisation differs by asset class. It would appear that some asset classes, for example CDS, are already highly standardised compared to other asset classes such as equity derivatives. There may be valid reasons for this but as a general principle CESR is of the view that greater standardisation could be achieved. CESR is therefore keen to solicit market views on whether regulators should prioritise focus on a) a certain element of standardisation and/or b) a particular asset class.

54. As highlighted above, much work is underway at the global level to deliver change to these markets. To date much of this work has been industry driven but the question now faced by regulators is whether current progress is sufficient, how best to build on current industry initiatives; and whether regulatory intervention is needed.

55. In particular, CESR has identified the use of electronic confirmation systems as one measure which could potentially deliver benefits to the market. CESR invites market participants to provide information on the potential costs of introducing a mandatory electronic confirmation requirement for European trading of OTC derivatives so that CESR can take an informed decision when making its final recommendations to the European Commission.

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

²⁴ http://www.newyorkfed.org/newsevents/news/markets/2010/100301_letter.pdf

²⁵ Please note that the Dodd-Frank Wall Street Reform and Consumer Protection Act and the Restoring American Financial Stability Act were passed by the Senate of the United States on 15 July and, at the time of finalising this paper, they are pending the U.S. President's signature to become law.



impact of the limitations to standardisation? Are there any other elements that should be considered?

- Q3: Do you agree that greater standardisation is desirable? What should be the goal of standardisation?**
- Q4: How can the industry and regulators continue to work together to build on existing initiatives and accelerate their impact?**
- Q5: Are there any obstacles to standardisation that could be removed by regulatory action? Please elaborate.**
- Q6: Should regulators prioritise focus on a) a certain element of standardisation and/or b) a certain asset class? Please provide supporting rationale.**
- 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.**

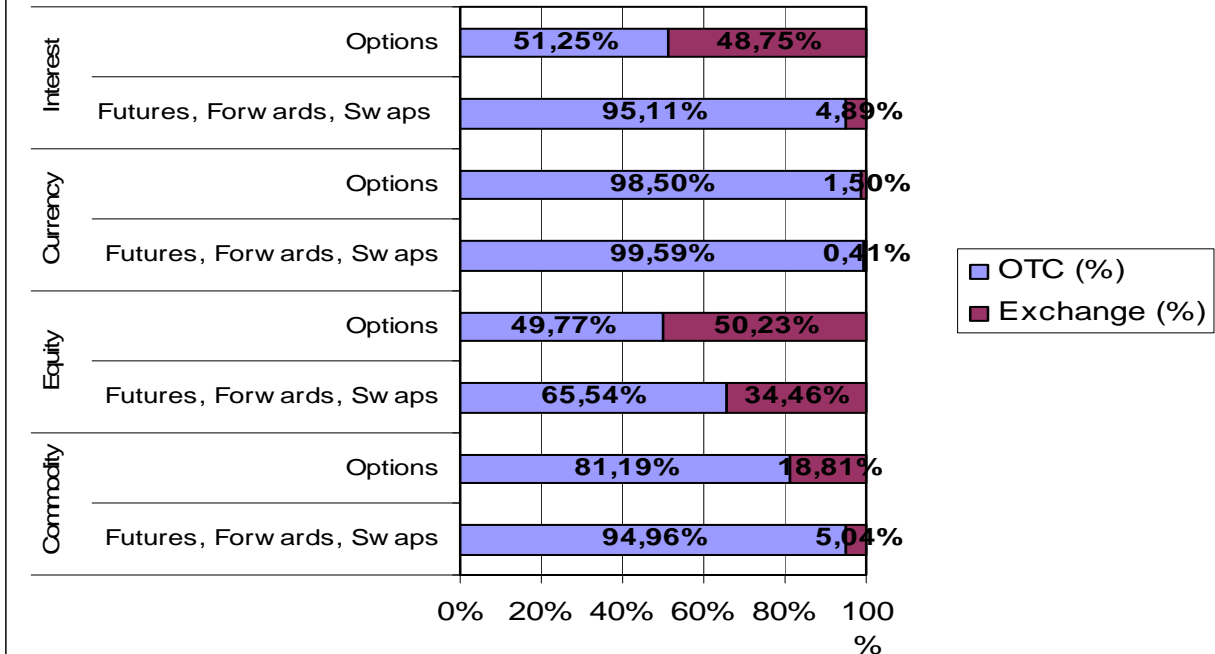
3. EXCHANGE TRADING

56. 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.

3.1 Assessment of the degree of exchange trading of OTC derivatives

57. 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.
58. 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.

**Market Share OTC and Organized Exchange,
Notional Amount Outstanding, December 2009**



*Source: Based on Semi-annual OTC Derivatives Statistic at December 2009 and Statistic on Exchange Traded Derivatives, BIS; Annual Statistic, 2009, WFE.

59. Volumes of derivative trading, both exchange and OTC, grew steadily in the years before the crisis. However, the exchange segment has grown faster than the OTC segment. This is widely perceived to be a result of the increasing standardisation of derivatives contracts which facilitates exchange trading. Other contributing factors are a number of advantages offered by on-exchange trading: price transparency, risk mitigation and transaction costs are among the most important²⁶.

3.2. Benefits and limitations of exchange trading of standardised OTC derivatives

60. 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.

61. 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.

3.2.1. Benefits of exchange trading

62. The following benefits may be attributed to exchange trading in general and applicable to derivatives in particular: trading on organised platforms provides a high level of transparency, enhances liquidity, ensures efficiency and risk reduction, provides for an equitable access and treatment to market participants.

3.2.1.1. Transparency

²⁶: Deutsche Börse Group, *Global Derivatives Markets – A Blueprint for Market Safety and Integrity*, 2009.



63. Trading on organised platforms provides a high level of transparency and therefore a reduction of information asymmetry. Organised platforms typically offer pre-trade transparency, tailored to the needs of the various markets.
64. Furthermore, trading on exchange ensures that price and other trade-related information is publicly displayed and is directly available to all market users. It therefore improves price transparency which in turn ensures efficient price discovery and pricing of assets, allows for comparability and strengthens risk management in allowing for better understanding of the products by users and better risk assessment.
65. Transparency to regulators is also better ensured when trading takes place on organised platforms. Information on trades made on exchange are automatically captured and available to regulators in real-time. There is also likely to be a clearer trail in terms of positions and exposures.
66. Conversely, due to the lack of transparency of OTC trading, it is difficult to get a fair view of the transactions conducted on these markets; in particular, there is no view on positions for market supervisors. This is the result of the very bilateral nature of the market that makes it opaque to parties outside a particular transaction. Opacity may affect other market segments (as the price determined in derivatives markets may be used to calculate the price of other instruments).

3.2.1.2. Price formation

67. Pricing of derivatives traded on-exchange is carried out directly by market participants interacting in a multilateral trading venue whose operator limits its role to bringing together or facilitating the bringing together of multiple third party buying and selling interests but never enters into the trades in its own account.

3.2.1.3. Liquidity

68. Trading on organised platforms can enhance liquidity. On benchmarks contracts, current experience shows that specialist proprietary trading firms provide additional liquidity on such platforms, whereas OTC markets mainly consist of inter-bank business. Tight bid/offer spreads and deep liquidity can therefore be found on organised trading platforms, particularly for benchmark derivatives contracts.

3.2.1.4. Operational efficiency

69. On-exchange processing offers efficiency along the total execution process. In particular, it allows for higher confirmation rates (virtually 100% real time according to market operators). This reduces risks of errors significantly and ensures certainty of execution.
70. Almost all exchanges use a central counterparty. Transactions done on exchange therefore benefit from a straight-through processing from trading to clearing and settlement. OTC traded derivatives indeed imply inherent risks, particularly bigger operational risks than on-exchange (although risks may be reduced, in some cases and depending on the level of standardisation, through bilateral clearing, netting, portfolio compression etc.).
71. Exchange trading also offers a variety of different trading schemes.

3.2.1.4. Equal market access

72. Trading on-exchange is open to a broader set of participants, and provides them for equal access to the market. By contrast, OTC trading is by nature bilateral; in addition, the level of concentration in terms of participants tends to be high on the latter markets.

3.2.2. Limitations of exchange trading

73. Exchange trading of derivatives has limitations that may vary depending on the type of participants involved and their focus. There are indeed a number of pre-requisites related to exchange trading of derivatives products among which the need for the contracts to be standardised, the inability to customise contracts, hence the lack of flexibility and the potential lack of match with the customers' needs, and the limited possibility for product innovation. Specific transparency and liquidity issues are also raised by some big market participants.

3.2.2.1. Standardisation requirement

74. Trading on organised platforms requires standardisation. The type of contracts traded on organised platforms may therefore not cater for the full range of derivatives users risk management needs. The ability to build tailor-made derivatives contracts according to the specific needs of counterparties (covering specific hedging needs) cannot be met with an exchange traded product: wholesale market participants use OTC derivatives to address specific clients' needs such as hedging and accounting risks (e.g. other delivery locations than the ones offered by exchange-traded commodities contracts).

75. In this respect, OTC markets offer the ability to customise and hence to trade flexible and bespoke contracts that cater for the full range of derivatives users needs to manage specific/non standard risks. Wholesale market players therefore usually have a commercial preference for these products, particularly in cases where they look to hedge their risks.

76. Furthermore, some already standardised products are not currently traded on exchange as their own features require flexibility (for instance interest rate swaps which are novated every day, or index CDS because of restructuring events).

3.2.2.2. Room for innovation

77. It may be observed that, traditionally, innovative products are first developed OTC, and traded on exchange when they become mature. With respect to product innovation and diversity, OTC markets offer more possibilities than what is practically possible on exchange, due to the very nature of such markets. Consideration should be given to leaving room for innovation to the market.

3.2.2.3. Transparency/liquidity

78. Some stakeholders argue that the public transparency offered on organised trading venues may be an issue for some wholesale participants, especially hedging counterparties, that may want to avoid that the market moves against them. They raise the concern that imposing exchange trading coupled with excessive transparency to some types of products could harm liquidity in some products and even disincentivise participation in these derivatives contracts. One way of preventing this to happen is a proper calibration of the transparency requirements on organised trading venues by the use of waivers for pre-trade transparency and thresholds and delays for post-trade transparency.

79. The smaller size of transactions traded on exchange is also raised as being an issue for wholesale participants having a use of derivatives markets; they highlight that the typical unit size is currently higher in OTC markets, due to the professional participation in these markets and the bespoke nature of the contracts.

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?

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



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.

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

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

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

80. 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.

81. CESR has undertaken a high-level assessment to better understand the characteristics and specifically the degree of standardisation needed for an OTC derivative contract to be eligible for trading on an organised trading platform.

82. 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.

Additional factors to consider

83. Whilst a high degree of standardisation of these elements is important, this may not be sufficient to successfully support trading on organised trading platforms. In practice existing exchanges will look to design similar contracts for successful OTC derivatives. In some instances active and liquid markets have subsequently developed and in other instances they have not.

84. It is therefore clear that other supporting factors need to be in existence in order to support trading on organised trading platforms. In particular, CESR is of the view that the following factors are also important considerations:

- **The size of the underlying market** – A liquid and active underlying market can better support trading of derivative contracts on organised trading platforms (for example the existence of a benchmark bond for bond futures contracts).
- **The size and diversity of market participants** – Successful exchange-traded contracts generally appeal to a wide variety of market participants. For example, beside wholesale investors, exchange contracts can also offer smaller investors and retail clients a way of accessing markets which may previously be unavailable to them in the OTC space.
- **Liquidity** – Coupled with the two points mentioned above a certain degree of market liquidity is needed in order to attract a sufficient pool of buying and selling interest for a contract to be traded on an organised trading platform.



- **Availability of CCP clearing** – In order for a derivative contract to be eligible for CCP clearing it will already need to exhibit a sufficient degree of standardisation as well as be supported by reliable and transparent price feeds to allow the clearing house to successfully risk manage the position. The availability of CCP clearing is therefore viewed as a useful starting point for contracts which exhibit the appropriate characteristics for trading on organised platforms, but this is not necessarily the only consideration. There may be some instances where OTC derivative contracts which are not eligible for clearing may be eligible for trading on an organised trading platform and vice versa. CESR is keen to further explore this point.
- **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.

Questions:

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.

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?

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.

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.

CESR wishes to take an informed assessment as to the OTC derivative contracts which could successfully be traded on an organised trading platform but are currently not traded/are currently traded on such a platform but only to a limited degree.

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

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.

3.4 Concept of 'exchange trading' in the context of OTC derivatives

85. The European Commission Communication dated 20 October 2009 states the following:

"The G20 agreed that 'all standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate'. In the EU, this implies ensuring that eligible trades for exchange-trading take place on organised trading venues, as defined by MiFID²⁷. Almost all derivatives exchanges use a central counterparty. Adding exchange-trading to central clearing would eliminate the bilateral nature of concluding

²⁷ The Commission states in a footnote that this includes "Regulated Market, Multilateral Trading Facility, or Systematic Internaliser".



*trades, resulting in highly visible prices, volumes and open interest, and facilitate market access*²⁸.

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 non-discretionary 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.

88. In line with the Commission’s Communication of October 2009, CESR is evaluating what kind of trading meets the Commission’s criteria mentioned above and how this may translate into the EU legal environment and the MiFID context. When assessing the criteria, the bilateral/multilateral aspect of the transaction is particularly relevant in the context of the price formation process. If MiFID is taken as a model, it defines RMs and MTFs as ‘multilateral systems operated and/or managed by a market operator, which bring together or facilitate the bringing together of multiple third-party buying and selling interests’ (Article 4(1)(14) and (15) of MiFID) as opposed to bilateral systems where an investment firm enters into every trade on its own account and not as a riskless counterparty interposed between the buyer and the seller (Recital 6 of MiFID). On the other hand, MiFID currently treats RMs, MTFs and systematic internalisers (SIs) as trading venues.

89. As regards single dealer platforms, which are not within any MiFID defined category, it could be considered that these platforms currently acting in the OTC space do not meet all of the above criteria, including that trading in these platforms is bilateral in nature. However, a question might be raised as to whether a trading venue might also be considered to fulfil the requirement of being a multilateral trading system on the basis of its ability to make pricing information (both pre- and post-trade) available on a multilateral basis. In developing its advice on the basis of the European Commission’s Communication, CESR is keen to discover whether there is a role to be played by single-dealer platforms that make firm quotes and pricing information available to all participants and therefore support the wider price formation.

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.

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.

Regulated markets and MTFs:

90. RMs and MTFs are multilateral systems which “bring 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”²⁹. According to MiFID, they “represent

²⁸ Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, the Committee of the Regions and the European Central Bank. Ensuring efficient, safe and sound derivatives markets, (Ref. COM (2009) 563 final), page 8.

²⁹ Directive 2004/39/EC on Markets in Financial Instruments (MIFID), Article 4(1)(14) and 4(1)(15)



the same organised trading functionality³⁰. 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.

91. 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.
92. 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 RM³¹.

Systematic internalisers

93. Systematic internalisers (SI) are “investment firms which, on an organised, frequent and systematic basis, deal on own account by executing client orders outside a regulated market or an MTF”³². They undertake bilateral transactions.
94. The investment firms performing the activity of systematic internalisers in shares are subject to specific and limited pre-trade transparency requirements: for liquid shares, they have to publish firm bid or offer quotes for sizes up to standard market size with no minimum size³³.
95. In addition, the activity of internalisation has to be performed according to non-discretionary rules and procedures³⁴ but internalisers are not required to provide open access and have discretion as to the counterparties they wish to trade against.³⁵
96. 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.
97. At the moment, CESR is reviewing the definition of SI for equity markets³⁶, exploring whether the SI definition requires clarification and whether or not the obligations that the definition entails should be recalibrated.
98. As part of this consultation process CESR is keen to understand from market participants whether in view of existing trading practices the systematic internaliser regime, as applied to shares, is relevant for the trading of OTC derivatives.

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

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

Crossing systems

³⁰ Directive 2004/39/EC, recital 49

³¹ Directive 2004/39/EC, Articles 14(4) and 42(1)

³² Directive 2004/39/EC on Markets in Financial Instruments (MIFID), Article 4(1)(7)

³³ Article 27 MiFID.

³⁴ Article 21(1)(a) MiFID Implementing Regulation. See also recital (50) MiFID.

³⁵ Article 21(1)(a) MiFID Implementing Regulation.

³⁶ Consultation Paper on CESR Technical Advice to the European Commission in the Context of the MiFID Review – Equity Markets (CESR/10-394).



99. CESR has recently consulted³⁷ on eventual policy initiatives to regulate crossing systems/processes, which are defined as ‘firms in the EU who operate systems that match client order flow internally’. Generally, these firms receive orders electronically, utilise algorithms to determine how they should best be executed (given a client’s objectives) and then pass the business through an internal system that will attempt to find matches. Normally, algorithms slice larger orders into smaller orders before they are sent for matching. Some systems match only client orders, while others (depending on client instructions/ permissions) also provide matching between client orders and ‘house’ orders.
100. The current CESR consultation on crossing networks is for equity instruments only. However, CESR is keen to know whether the proposed regime is relevant for the trading of derivatives (for details of the proposed regime, see CESR’s Consultation Paper in the context of MiFID Review – Equity Markets³⁸),

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”?

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

101. 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 Senate³⁹, 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.*”⁴⁰.
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

³⁷ Consultation Paper on CESR Technical Advice to the European Commission in the Context of the MiFID Review – Equity Markets (CESR/10-394).

³⁸ Consultation Paper on CESR Technical Advice to the European Commission in the Context of the MiFID Review – Equity Markets (CESR/10-394), p. 28-29.

³⁹ Please note that the Dodd-Frank Wall Street Reform and Consumer Protection Act and the Restoring American Financial Stability Act were passed by the Senate of the United States on 15 July and, at the time of finalising this paper, they are pending the U.S. President’s signature to become law.

⁴⁰ For a summary of the text approved, see <http://www.opencongress.org/bill/111-h4173/show>



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?

Preliminary conclusion:

108. CESR is of the view that 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.
109. Given the structure of OTC derivative markets such an approach appears too narrow and consideration should be given to how the regime needs to be adapted in order to meet the overarching commitment made by G20 members

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?

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.

3.5. Assessment of existing market-led and regulatory initiatives promoting exchange trading

110. In September 2009, G20 Leaders agreed in Pittsburgh that all standardised over-the-counter (OTC) derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012. Progress is being made to achieve implementation of these objectives, including industry efforts to meet commitments made to supervisors; multiple work streams are underway in international bodies and legislative processes in major jurisdictions.
111. Furthermore, the financial regulatory reform plan of the current US administration addresses widely the issue of OTC derivatives and their treatment in the post-crisis situation. Draft legislative bills under consideration seek to introduce a requirement that all standardised derivatives are transacted on a swap execution facility⁴¹.

⁴¹ Please note that the Dodd-Frank Wall Street Reform and Consumer Protection Act and the Restoring American Financial Stability Act were passed by the Senate of the United States on 15 July and, at the time of finalising this paper, they are pending the U.S. President’s signature to become law.

112. Finally, and to support implementation of the G20 clearing and trading objectives, in April 2010, at the initiative of the 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.
113. At the industry level, and as outlined in Section 2.5. the G14 major derivatives dealers and a number of buy-side institutions have made a number of commitments to OTC derivative supervisors for improving the resilience of OTC derivative markets, although none of these specifically relate to commitments to carry out derivative transactions on an exchange.

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

3.6 Preliminary conclusions: assessment and policy views on ‘exchange trading’

114. 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.
115. Trading on organised platforms of standardised contracts indeed offers transparency that prevents information asymmetry and provides efficiency in the price formation mechanism/process. It also lowers systemic risk by *in fine* enabling clearing houses to get reliable pricing information and determine the liquidity of particular contracts. Furthermore, exchange trading takes steps to prevent against market abuse through the exchanges’ market surveillance schemes. There would therefore be value for sufficiently standardised contracts to be traded on such platforms.
116. Despite the clear benefits of trading OTC derivatives on organised trading platforms, bespoke contracts that are specifically built to address specific hedging concerns and that may involve a specific advice and require a highly customised execution service are not suitable for trading on organised trading platforms, due to their bilateral and ad hoc nature. 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.
117. However, exchange trading of derivatives can deliver certain benefits. CESR is therefore of the view that exchange trading of standardised derivative contracts should be incentivised as much as possible. There are currently several international initiatives with the aim of increasing transparency, promoting central clearing through a CCP and introducing trade repositories. Against this background and as a preliminary opinion, CESR is in favour of incentivising the use of organised trading venues but continues to consider whether mandatory usage is desirable, taking into account the discussions currently taking place on this issue in other jurisdictions and international fora. Thus, CESR would like to further explore with market participants which kind of incentives could effectively promote exchange trading.
118. In order to reach the G20 and EU Commission objectives, i.e. on which types of organised platforms it would be appropriate to trade sufficiently standardised OTC derivatives, CESR is



considering whether these organised platforms would need to fulfil the key criteria as listed in paragraph 86 and 87 above or only those listed in paragraph 86. In any case, CESR is of the view that it would be useful that regulatory intervention promotes, supports and incentivises further trading of standardised OTC derivatives on organised platforms meeting the above mentioned criteria.

119. In line with the previous paragraph, CESR is of the view that one of the main benefits of exchange trading relates to providing market participants with helpful pre- and post-trade information. In this context it is important to note the parallel work which is being undertaken through CESR (Ref. CESR/10-510) which is considering the need for introducing a mandatory transparency regime for OTC derivatives. The outcome of this work will be ultimately reflected in the conclusions drawn from this consultation paper.

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

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.

4. Conclusion and next steps

120. The OTC derivatives market is a very diverse market in terms of traded products, market participants, trading strategies etc. It is therefore difficult to draw general conclusions that are applicable to all asset classes that are the scope of this paper: credit, equity, interest rate, commodity and foreign exchange derivatives.

Standardisation

121. In terms of standardisation of OTC derivatives, the industry has made substantial progress. This paper has made an assessment of the three main aspects of standardisation: legal, product and process standardisation. In terms of preliminary conclusions it appears that credit derivatives are the most standardised asset class in terms of use of standard legal documentation, standard contract terms and the wide adoption of electronic trading confirmation systems in the inter-dealer market. OTC equity derivatives appear to be at the other end of the standardised spectrum.

122. Aside from highly standardised derivatives, OTC derivatives are tailored particularly in order to permit parties to enter into transactions to hedge the risk of a relatively unique underlying and structure transactions with relatively unique terms and conditions to match their relatively unique risk profile. OTC derivatives are also widely used by non-financial firms for hedging purposes. CESR is therefore of the view that firms should be able to retain the flexibility to customise aspects such as standard valuation, payment structures, payment dates, and so forth for OTC derivative transactions. Nevertheless, while recognising the role bespoke products can play, CESR is of the view that greater standardisation of OTC derivatives contracts can deliver efficiency benefits to the market.

123. In particular, CESR has identified the use of electronic confirmation systems as one measure which could potentially deliver benefits to the market and invites market participants to provide information on the potential costs of introducing a mandatory electronic confirmation requirement for European trading of OTC derivatives so that CESR can take an informed decision when making its final recommendations to the European Commission.

124. More generally, CESR is keen to explore with the industry what measures could be taken to foster a higher degree of standardisation and how CESR or EU-wide regulation could help to increase the current level of standardisation. As the degree of standardisation differs by asset class, CESR particularly solicits views on whether regulators should prioritise their focus on a) a certain element of standardisation and/or b) a particular asset class.

Exchange trading

125. The OTC segment in derivatives trading currently accounts for approximately 85-90% of the market measured in notional amount outstanding. Although this overstates the market size of the OTC segment due to the different ways of counting the data (gross versus net), it may be concluded that derivatives are primarily traded OTC and that the share of OTC trading is substantial throughout all asset classes.
126. Exchange trading of derivatives has a number of benefits like providing a high level of pre- and post-trade transparency, enhancing liquidity, providing efficiency in price formation and risk reduction, allowing equitable access and treatment of market participants. There are however also some limitations or pre-requisites to exchange trading of derivatives, including the need for the contracts to be standardised. These barriers to exchange trading may continue to exist and limit the growth of the share of organised markets in derivatives trading. However, as standardisation is promoted, it is likely to have an impact on further trading on organised trading platforms.
127. Taking into account the benefits of trading of derivatives on organised markets, CESR is of the view that exchange trading of standardised derivative contracts should be incentivised as much as possible. As a preliminary opinion, CESR is in favour of incentivising the use of organised trading venues but continues to consider whether mandatory usage is desirable, taking into account the discussions currently taking place on this issue in other jurisdictions and international fora.

Next steps

128. CESR invites responses to this consultation paper by 16 August 2010. All contributions received will be published following the close of consultation, unless the respondent requests its submission to be confidential. An open hearing will be organised during the consultation period for interested stakeholders on 11 August. Based on the outcome of the consultation process, CESR will publish its final position as a technical advice to the European Commission.



Annex I: Summary of consultation questions

- 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?
- 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?
- Q3:** Do you agree that greater standardisation is desirable? What should the goal of standardisation be?
- Q4:** How can the industry and regulators continue to work together to build on existing initiatives and accelerate their impact?
- Q5:** Are there any obstacles to standardisation that could be removed by regulatory action? Please elaborate.
- Q6:** Should regulators prioritise focus on a) a certain element of standardisation and/or b) a certain asset class.? Please provide supporting rationale.
- 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.
- 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?
- Q9:** Which sectors of the market would benefit from/ be suitable for (more) exchange trading?
- 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.
- Q11:** Do you identify any other elements that would prevent additional OTC derivatives to be traded on organised platforms?
- Q12:** How should the level of liquidity necessary/relevant to exchange trading be measured?
- 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?
- 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.
- Q15:** Is contract fungibility necessary in order for a derivative contract to be traded on an organised trading platform? Please provide supporting rationale.
- Q16:** Which derivative contracts which are currently traded OTC could be traded on an organised trading platform? Please provide supporting rationale.



- 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.
- 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.
- Q19:** Do current trading models and/or electronic trading platforms for OTC derivatives have the ability to make pricing information (both pre- and post-trade) available on a multi-lateral basis? Please provide examples, including specific features of these models/platforms.
- Q20:** Do you consider the SI-regime for shares relevant for the trading of OTC derivatives?
- Q21:** If so, do you consider that the current SI-regime provides the benefits described above which ‘exchange trading’ may offer or are amendments needed to the SI obligations to provide these benefits to the OTC derivatives market?
- Q22:** Which characteristics should a crossing network regime, as envisaged in the review of MiFID, have for a CN to be able to be qualified as a MiFID “organised trading venue”?
- 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?
- 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?
- 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.
- Q26:** Are there any market-led initiatives promoting ‘exchange trading’ that the regulators should be aware of?
- Q27:** Which kind of incentives could, in your view, efficiently promote greater trading of standardised OTC derivatives on organised trading venues? Please elaborate.
- 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.