Commission Communication: “Ensuring Efficient, Safe and Sound Derivatives Markets”

A response by the Futures and Options Association

September 2009
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1. Introduction

1.1 The Futures and Options Association (FOA) is the principal European industry association for over 170 firms and organisations engaged in the carrying on of business in futures, options and other derivatives. Its international membership includes banks, financial institutions, brokers, commodity trade houses, energy and power market participants, exchanges, spread betting companies, clearing houses, IT providers, lawyers, accountants and consultants (see Appendix 1).

1.2 Subject to the observations in this response, the FOA broadly supports the overall objective of the Communication, namely, to ensure “efficient, safe and sound derivatives markets” and to improve operational efficiency and strengthen post-trade functionality in a way which will “allow them to fulfil their economic role”, but without endangering the stability of the system (para 5) (see also FOA press release at Appendix 4) and recognises the Commission’s role in encouraging the industry to use CCP clearing in relation to vanilla CDSs.

Summary of key points

1.3 By way of summarising the points made in this response, the FOA:

(a) supports the Commission’s recognition of the economic importance of derivatives (see para 1.3);

(b) does not accept the general statement that derivatives were “at the centre of the financial crisis” (see para 1.4);

(c) supports the Commission’s continued intention to work constructively with the industry;

(d) while recognising that the Commission will take careful account of the US approach to developing a framework of closer regulation of the OTC derivatives markets, is concerned over the market and risk management consequences in certain key aspects of that approach proposed in the US Treasury “legislative language” sent to Capitol Hill on 11th August (see paras 1.7, 1.8, 1.9 and 6.2);

(e) is concerned at the assumption that when derivatives are used for other than hedging purposes, it will be pure speculation, when, in fact, the non-hedging use of the derivatives markets covers a wide spectrum of trading motivation (see para 2.3);

(f) believes that the drive to enhance operational efficiency should generally be left to customer demand and market pressure (other than where there is a manifest failure which undermines public policy and regulatory objectives) – and that includes the issue of electronic trade execution (see paras 3.1 and 3.2);

(g) believes that regulatory intervention which has a direct impact on market structure and risk management capability and costs needs to be handled with extreme caution, particularly with regard to defining standardisation and encouraging the use of standardised products, the issue of transparency, the use of CCP clearing, the approach to execution and the use of collateral to the extent that, while there are positive aspects to a number of these proposals, there is also a real potential for market distortion and the undermining of risk management capability (see Section 5); and
(h) has provided a detailed response to questions posed in the Commission’s Staff Working Paper Consultation Document: “Possible Initiatives to Enhance the Resilience of OTC Derivative Markets” in Appendix 2 to this response and, in doing so, has collaborated with the International Swaps and Derivatives Markets (ISDA) and the Wholesale Market Brokers Association (WMBA).

The role of derivatives (see also Section 2)

1.4 The FOA very much supports the Commission’s recognition of the economic importance of derivatives, namely, that:

(a) derivatives are “important tools for economic agents to transfer risk” (para 2.1);

(b) derivatives “benefit the economy” (para 2.2);

(c) “most derivatives depend on observable market prices” (e.g. interest or the exchange rates) (para 2.3);

(d) “OTC markets are markets for professional investors” (Introduction to the Commission Staff Working Paper); and

(e) “derivatives play a fundamental role in price discovery” and “allow for pricing of risk that might otherwise be difficult to price because the underlying assets are not sufficiently traded” (para 2.1.2 of the Commission Staff Working Paper).

For these reasons, it is essential that wholesale institutional and corporate counterparties are able to access a broad range of financial instruments designed to facilitate risk transfer to manage their business and transactional risks - which are often complex and highly individualised – effectively, cost efficiently and without undue basis (as well as credit) risk. In some cases this can be addressed through standardised exchange transactions or through plain “vanilla” (and, increasingly, CCP cleared) OTC transactions. In other cases, the risks to be managed may require a more complex tailored transaction which can only be executed, by its very nature, off-exchange and which will not be susceptible to CCP clearing. Access to these transactions should, therefore, not be impeded by the adoption of capital rules or regulatory constraints which are anything other than authentically risk-based for reasons set out in paras 3.3 to 3.5.

1.5 In para 2.1, the Communication defines “derivatives” as including standard products which are “typically traded in organised trading venues where prices are publically displayed (e.g. derivatives exchanges)” and non-standardised derivatives, which are “traded off-exchange or, as commonly called, over-the-counter (OTC) where prices remain private”. However, without drawing any distinction between different classes of derivatives or exchange-traded or OTC derivatives, it states in the opening paragraph to Section 2 that derivatives “have been at the centre of the financial crisis”.

The FOA does not accept the generality of this statement for the following reasons:

(a) as acknowledged in the Introduction to the Commission’s Staff Working Paper, the difficulties experienced by Bear Stearns, Lehman’s and AIG “originated outside the OTC derivative markets and was initially confined to a small segment of the OTC market (i.e. credit derivatives)” – which reflects the view of most authorities that derivatives (e.g. interest rate, equity, foreign exchange or commodity derivatives) were not “at the centre of the financial crisis”;
(b) exchange-traded derivatives were not “at the centre of the financial crisis” and, even more to the point, performed well prior to and through its duration, even to the point where regulatory authorities are now looking at ways of actively encouraging the use of exchange-traded derivatives as a preference to trading in OTC derivatives;

(c) to some extent, this statement reflects the mistaken assumption that all OTC products are “derivatives” when, in fact, a significant percentage of such transactions are physical spot and/or forward deals or are structured products (such as those that were at the heart of the crisis) with little or no “derivative” element attached to them;

(d) it is worth remembering that, in any event, the primary causes of the crisis were more in the nature of a “people problem” than a “product problem” (e.g. excessive stakeholder pressures, weaknesses in risk management and corporate governance and in regulatory structures and communication) and that issues which require the application of robust risk management and corporate governance standards are not indicative of weaknesses within a particular market of product.

Industry input

1.6 The FOA notes that the Commission “will continue to work constructively with industry to ensure the implementation of its commitment to introduce EU-based central clearing by end-July 2009” and anticipates that this expression of working constructively with the industry will apply to all aspects of repair and improvement identified in the Communication (i.e. cooperation will go beyond the process of formal consultation.)

For example, the FOA applauds the Commission in its establishment of the Derivatives Working Group and the Monitoring Oversight Group as positive examples of how the industry can contribute to the working-out of regulatory policy in ways that are practical and deliverable and believes that this has been both useful and positive for both Commission officials and industry participants.

The US approach

1.7 The FOA recognised that there are positive aspects to the US approach (which are replicated in the Commission’s own proposals) but it is concerned over the US definition of standardisation in para 5.3 and its regulatory policy of “encouraging” as many OTC transactions to be executed on an exchange or an alternative swap execution facility (“ASEF”) (the regulatory requirements for which are, as yet, unclear) in para 5.9. However, there is now the US approach to position limits which, in the US Treasury’s “legislative language” for the proposed Over-The-Counter Derivative Markets Act of 2009, is likely to result in:

(a) stricter position limits;

(b) a wider application of position limits (e.g. to commodity contracts that “perform or affect a significant price discovery function” of a regulated market); and

(c) more limited exemptions to those limits.

As stated by Chairman Gary Gensler in his opening statement at the CFTC hearing on 28/7/09:

“As we consider setting position limits on future exchanges, I believe that the Commission must urgently work with Congress to secure additional authorities, including aggregate position limits, to prevent market participants from moving to the over-the-
counter market or onto foreign exchanges. The CFTC must be able to set aggregate limits on all persons trading OTC derivatives that perform or affect a significant price discovery function with respect to regulated markets that the CFTC oversees. The clear purpose behind the CFTC application is to empower (where it can) the CFTC to establish aggregate position limits across all markets in order to ensure that traders are not able to avoid position limits in a US market by moving to a related exchange or market, including international markets.”

It is important to note that the CFTC’s current imposition of US position limits on the issuance of its no-action letters to non-US exchanges permitting US market access is limited only to those contracts which are priced or settled off a US-regulated contract. The language in the above quotation and confirmed in the “legislative language” proposed by the US Treasury, however, is significantly wider as all persons trading OTC derivatives will be required to observe US position limits “where the contract performs or affects a significant price discovery function” with respect to a US-regulated market. While this will undoubtedly impact on OTC market liquidity, the question also arises as to whether or not this significantly broader basis of application will, at some stage, be extended to non-US regulated markets with the result that it will capture a much broader spectrum of non-US exchange contracts.

More positively, the FOA notes the exemptions available (a) to certain aspects of these proposals for small-sized physical market participants; (b) with regard to the imposition of margin on non-CCP cleared OTC positions, for the hedging activities of physical markets participants; and (c) for physical OTC FX dealings (although these latter would not be covered, in any event, since they are not included as derivatives within MiFID).

By contrast, the EU regulatory position is to rely on the more sophisticated and market sensitive approach of using position accountability and transparency to monitor the size of positions in markets and, where relevant, require market participants to unwind their positions if they have the effect of distorting a market or the price formation process in that market. Interestingly, fresh data produced by the CFTC has demonstrated that – contrary to assumptions made in the US - the London markets are not a “loophole” for excessive speculative activity.

1.8 The FOA would urge the Commission, in considering the US approach, to bear in mind that – unlike the case in the EU – the US OTC markets, as it is put in the US Treasury release, “have largely gone unregulated since their inception”.

1.9 The intention of the US authorities to export its regulatory approach is reflected in the US Treasury White Paper, which states that the US’s “leadership position in the international community” should be used to promote “initiatives compatible with the domestic regulatory reforms described in this Report” and that “as we work to set high regulatory standards here in the US, we must ask the world to do the same”. Its objective is to prevent US regulatory avoidance, but it is also perceived as preventing possible business migration which could result from the US adopting a more business restrictive approach to regulatory repair than might be adopted in other jurisdictions outside the US. This is underpinned by the view in some quarters in the US that the expected EU approach will be “looser” that that adopted in the US (notwithstanding that it may actually be more market-sensitive and/or appropriate).

2. “Derivatives and Derivative Markets” (Section 2)

2.1 The FOA has already commented on the statement that derivatives “have been at the centre of the financial crisis” in para 1.4 of this response.
2.2 The FOA has attached at Appendix 3 an explanatory memorandum on derivatives markets which enlarges on the points set out in this paragraph and which was drafted by FOA, ISDA and FESE and produced for the European Parliamentary Financial Services Forum (EPFSF).

2.3 Generally, the FOA broadly agrees with the analysis of derivatives set out in this section and in the accompanying Commission Staff Working Paper, but is concerned at the view that they are used solely for hedging or speculative purposes. The fact is that trading motivation ranges from hedging to asset allocation/diversification to medium-term financial trading to arbitrage trading to short-term speculation (which acts as an essential provider of liquidity to other market participants, including commercial users of the markets) – and these legitimate trading activities must be distinguished from market abusive or manipulative trading.

For example:

(a) the primary purpose and origin of derivatives is to provide a risk transfer mechanism in order to hedge, in the case of commodities, underlying physical positions and, in the case of financials, underlying portfolios and a variety of business and commercial risks;

(b) long-term positions in derivatives may be executed (and “rolled over”) for financial investment purposes which should not be confused with short-term speculative activity;

(c) commodity derivatives positions may be executed for asset diversification purposes in order to diversify portfolios by taking positions in instruments which move at different times in the economic cycle to more traditional forms of investment such as equities;

(d) as is pointed out in para 2.1.2 of the Commission Staff Working Paper, arbitrage trading is used to “connect markets by eliminating pricing inefficiencies between them”.

2.4 The FOA accepts that, where there is an absence of reliable or adequate public information, it can be difficult for market participants to determine whether their risks have been effectively hedged and/or to value the exposures undertaken by them. On the other hand, the lack of such public information does not apply to all OTC markets, in particular commodities and credit, as is recognised in the statement in the Communication in para 2.3 that “most derivatives depend on observable market prices (e.g. interest or the exchange rates)”.

2.5 The FOA does not accept the general assumption, as stated in the last paragraph of para 2.4 in the Communication, that “the characteristics of OTC derivative markets… increase uncertainty in times of market stress and accordingly pose risks to financial stability”. There are segments of OTC derivatives markets, with different types of market participants; they do not exhibit the same characteristics, and the risks they pose to the system are variable and, in some cases, negligible (e.g. commodity derivatives).

3. Managing Counterparty Risks

3.1 With regard to the importance of improving operational efficiency, the FOA would emphasise:

(a) that, in general terms, the drive to enhance operational efficiency should be a consequence of customer demand and market pressure rather than regulatory intervention, which should only become necessary where there is a manifest failure which undermines public policy and regulatory objectives;
(b) that, prior to the crisis, the industry was already introducing significant improvements into post-trade functionality and, in some cases, outsourcing post-trade functions to exchanges (e.g. BClear, SwapClear, RepoClear, ICE OTC Clear, Eurex OTC Clearing, CME Clearport);

(c) that the industry, particularly ISDA, have strengthened the OTC operational infrastructure by:
   - increasing the level of electronic processing of eligible trades;
   - enhancing the efficiency of trade confirmation processing;
   - reducing operational risk through portfolio compression; and

(d) its strong support for the drive to encourage the widespread use of electronic trade confirmation.

3.2 It follows from the above that the FOA would urge the Commission to leave the question of trade execution (as opposed to trade confirmation) to the dealers and their customers insofar as:

(a) market competitive pressures will increase the use of electronic execution (as it has done in relation to the execution of exchange-traded contracts);

(b) providing execution is accompanied by comprehensive transaction reporting to regulators as well as increased but commercially-sensitive levels of transparency (such as stipulated in MiFID), it is difficult to ascertain the regulatory deficiency that would justify regulatory intervention;

(c) some of the underlying asset classes are so bespoke that voice-broking will continue to be the preferred methodology of customers in certain markets; and

(d) only liquid and standardised contracts are eligible for clearing for the safety and soundness of CCPs.

3.3 The FOA notes the Commission’s recognition that “safety comes at a cost for its participants”. There is a significant risk that compelling the use of a CCP for contracts that are not standardised and imposing excessively high capital requirements for OTC transactions could increase significantly hedging costs to the point where it is simply not economic to incur that cost – and this would undermine directly the post-crisis imperative that firms and institutional and corporate counterparties must enhance their risk management capabilities.

3.4 For this reason and, in order to preserve the ability of corporate and institutional customers to continue to hedge their often differentiated and sometimes complex underlying risks effectively, the FOA believes it is important that:

(a) the Commission focus on process and legal uniformity versus product uniformity. Process and legal uniformity will contribute to the reduction of systemic and operational risk. Product standardisation could actually increase systemic risk as it will disallow clients to hedge their own bespoke risks;

(b) the need for market and product diversity is not distorted through the imposition of artificially high capital charges imposed on bilaterally-negotiated and collateralised OTC derivative transactions – other than where they are properly justified on grounds of risk;
(c) while the Commission should look to “strengthen counterparty risk management in bilateral trades”, it is critically important to take into account the different business models and asset bases of the broad variety of institutional and commercial counterparties which look to manage their risks through bespoke OTC derivatives (see para 5.9).

3.5 With regard to the observation that “OTC markets are much riskier than regulated trading venues, as the former are more opaque and counterparty relations more complex”, the FOA recognises that there is a greater degree of transactional security that applies to centrally regulated and more transparent trading venues, but would repeat its observations that the extent to which OTC markets are opaque varies from asset class to asset class and from product to product (and the FOA would refer again to the Commission’s observation that “most derivatives depend on observable market prices”). There is, potentially, a significant exacerbation in risk if customers and counterparties are compelled to use traditional standardised products on regulated trading venues rather than tailored OTC products which would otherwise provide a much better match to the underlying risk that is sought to be addressed. In other words, the drive to mitigate as effectively as possible credit risk should not be at the risk of exacerbating basis risk.

4. **Actions already taken by the Commission to improve financial stability in derivative markets**

4.1 The FOA recognises and supports the Commission’s objectives to

(a) intensify its oversight of the OTC markets and establish a more comprehensive and risk-based prudential and business conduct framework for OTC dealings;

(b) encourage the use of central counterparty clearing; and

(c) require transaction reporting of all OTC transactions to regulatory authorities.

4.2 With regard to the Commission’s “steps” to address the risks associated with OTC derivatives dealings, the FOA would make the following observations:

(a) With regard to the first “step”, the FOA supports the Commission’s drive to encourage the availability and use of central counterparty clearing for, as it is described, “eligible” CDSs on European reference entities and indices on these entities.

(b) With regard to the third “step”, the FOA recognises the importance of reviewing the prudential rules to ensure that they are accurately risk-based in their application to the trading of financial institutions, but would emphasise the importance of them being authentically risk-based and not “punitive”. It continues to be fundamentally important that dealing and risk management costs are not increased unduly to the disadvantage of users, particularly those who are looking to use these markets to manage their underlying risks;

4.3 With regard to the directive on hedge fund and other alternative investment fund managers, it is not clear why the regulatory approach to hedge funds is singled out for specific reference in this paper, which is focussing on derivatives markets. The Commission will be very familiar with the broad range of significant concerns that have been raised by a number of organisations regarding the direction and content of this Directive and calls for both the “sell side” and “buy side” for a substantial rewrite if EU-based constituent investment institutions are not to be competitively disadvantaged in a growing area of financial services.
5. The way forward: new initiatives to improve financial stability

5.1 The FOA very much supports the inherent and essential balance in the Commission’s statement that there is a need “to deal with OTC derivative markets to allow them to fulfil their economic role in a way which does not endanger the stability of the system”. The FOA understands entirely that there is a priority shift towards safer markets and a sounder financial system, but it continues to be important that the economic role of these markets is not impeded to the point where dealing, investing and risk management costs increase to such a level that they become uneconomic and/or where innovation, competitiveness and market liquidity becomes significantly impaired.

To this end, the FOA would urge the Commission to give full effect to the observation in para 4.4 of the Commission’s Staff Working Document that “legislation designed for the financial sector may not be adequately tailored to their activity and risk profile”, referring to participants and commodity derivatives transactions. This need for distinctive treatment will also apply in other markets where the counterparties and underlying asset classes are very different.

In this context, the FOA would refer to the observation in the UK FSA’s Discussion Paper 09/2 that “intervention by regulators explicitly designed to alter market structure needs to be taken with great caution” and that “regulatory intervention should focus on addressing risks, and not impose a specific market structure” (para 10.50).

Transparency

5.2 To this end, the FOA supports the objectives set out in (a) and (b) and, subject to the need to preserve commercial trading confidentiality, particularly in relation to illiquid or large-sized trades, in (c) and (d). The FOA notes that, as it is put in the Commission Staff Working Paper, there are “valid” arguments both in favour of and against the need for greater transparency of trading activity in non-equity markets. Particular reference is made to the adverse impact of disproportionate disclosure in less liquid markets – and the vulnerability of commercial participants as regards large-size trades. On the other hand, some participants are calling for greater transparency in order to “reduce the information asymmetry in favour of the major dealers”. The Markets in Financial Instruments Directive (MiFID) drew out all the different arguments in developing transparency requirements that could be held in common and provides a useful starting point for the debate, but that does not necessarily mean that all markets would be susceptible to a straightforward “read across” of those requirements, bearing in mind the importance of preserving acceptable market differences.

The FOA is not clear as to the implications of the terms “promote” and “centralised structures” when used by a regulatory authority.

Standardisation

5.3 The FOA would emphasise the importance of avoiding any distortions when it comes to defining or interpreting standardisation for the following reasons:

(a) Institutional and corporate customers and counterparties must be able to access non-vanilla or exotic OTC transactions as a matter of choice where it is necessary to manage their differentiated and often complex underlying risks. That freedom of choice should not be fettered by unnecessarily increased costs (e.g. as a result of the imposition of prudential rules which are excessive when measured against the real underlying risks)
(b) The US definition of standardisation (see Appendices 4 and 5), at the moment, deems any OTC transaction as standardised if it is capable of being centrally cleared by at least one regulated clearing house. This has a distorting effect, firstly, because the transaction may not, in real terms, be standardised and the only reason that it is capable of being cleared is that it is the subject of an uneconomically high margin call and, secondly, once deemed standardised, it will have to be centrally cleared at that uneconomic high price. Counterparties will be denied therefore the option of reducing their risk management costs by electing to bilateral collateralise the transaction (which, as indicated by the Commission, will, in any event, be “strengthened”). Surely, if that form of collateralisation is to be strengthened, then market counterparties should be part of the determination on eligibility.

(c) For the safety and soundness of the CCP, only standardised and liquid OTC derivatives contracts should be deemed eligible for clearing.

(d) The regulatory drive to “encourage” standardisation and deter, through the possible use of punitive capital treatment, non-standardised bilateral dealings will increase basis risk. As a result of risk management mismatches (which could be generated by regulatory intervention), counterparties will no longer be eligible for hedge accounting treatment and will be able to mark-to-market only one side of the risk position.

(e) One of the core targets for regulatory repair is to enhance risk management capability, but the drive to “encourage” standardisation may reduce the number of non-standardised contracts available in the market and so reduce risk management capabilities rather than enhance them.

(f) The FOA notes the Commission’s concluding statement in para 5.1 that one of the objectives of promoting standardisation is to make OTC derivatives eligible for on-exchange trading. The FOA recognises the advantages offered by on-exchange trading in terms of a centrally regulated marketplace and full price transparency, but would emphasise that:

- certain OTC products are inherently bespoke transactions not capable of standardisation (although they may be the subject of standardised documentation) and will be bilaterally negotiated as to quality, delivery, currency, price, etc. (e.g. commodity and equity OTC derivatives);

- it has always been open to customers and counterparties to trade on-exchange, where their underlying risks accommodate the use of a standardised hedging transaction – and recent indications are that there is a growing market-driven migration of derivatives business from the OTC markets to the on-exchange markets;

- one of the objectives of MiFID was to give customers and counterparties the choice of execution methodology, i.e. whether to trade on a central regulated market or a multilateral trading facility, or to execute directly with a principal dealer (and, in order to facilitate that choice, as already stated, MiFID introduced a set of enhanced price transparency requirements).

In this context, the FOA notes the UK’s FSA recognition that “not all CDS products are suitable for clearing… (and) will continue to be managed on a bilateral basis via collateral posting mechanisms)” (para 10.70) and the observation in the Turner Review that central counterparty clearing will only be “feasible for the roughly 50-75% of the CDS which is accounted for by standardised contracts (e.g. referencing a standard index); a large volume of bespoke contracts will continue to be traded in an OTC fashion” (page 83). The FOA also
notes comments from the London Stock Exchange that “The onus is on exchanges to respond commercially to come up with a model that works. I don't think the right way for regulators is to force inappropriate products onto the exchange” (Reuters, 3rd June 2009).

Central Data Repository

5.4 The FOA supports the use of central data repositories and believes that, providing EU regulatory authorities have full rights of access to data and are satisfied as to the level and quality of regulatory oversight, these objectives could be fulfilled through the use of non-EU repositories. This is the case in the CDS market, where the US Depository Trust and Clearing Corporation (DTCC) has the advantage of all the relevant information being concentrated in one organisation. For other OTC markets, FOA members support the establishment of repositories, although it is not necessarily the case that a single repository should be used for all OTC products. The FOA notes that the data held within these repositories should be available to regulators only.

CCP Clearing

5.5 As previously, the FOA supports the Commission’s drive to encourage the use of CCP clearing in relation to OTC contracts, but would point out that the industry already has, of its own initiative and prior to the crisis, developed the use of CCP clearing for a number of OTC asset classes (see para 3.1(b)).

5.6 The FOA notes and appreciates the fiscal risk arguments put forward by the Commission as to the advantages of CCP clearing being located in Europe, but also recognises the importance of choice:

- Choice involves the right to be able to access the cross-border delivery of clearing services into the EU by market infrastructure providers based in third countries (reflecting the common consensus amongst the international standard-setting bodies that the crisis should not result in a retreat to closed markets and protectionism);

- Choice was one of the key “drivers” behind the Clearing and Settlement Code for cash equities as well as the MiFID Directive.

The FOA notes the argument advanced by the ECB for establishing a CCP in the Eurozone for the purpose of clearing Euro-denominated CDSs. However, the Commission has rightly not suggested that a non-Eurozone European clearing house should be denied the opportunity of clearing Euro-denominated CDSs or that non-Eurozone European rules and supervision of non-Eurozone European CCPs are deficient. Many FOA members have reported that they were satisfied with the operation of Euro products in CCPs outside of the Euro area during the events of October 2008, most notably in London. Further, they have expressed confidence in the potential role of currency swaps lines in providing liquidity during these situations, should it be required. FOA members suggest a focus on further improving these crisis contingencies for CCPs, and building on the positive experience of central clearing during 2008.

Furthermore, it is difficult to justify the exclusion of a US CCP for clearing Euro-denominated CDSs. For example, it is not suggested that US rules and supervision are any less exacting than those that prevail within Europe and, in the current climate of closer coordination and more comprehensive and timely information sharing, it is unsettling to note that one of the arguments put forward for a European CCP is the suspicion that European supervisors would not have full and free access to information held by CCPs outside Europe.
In the circumstances, the FOA would urge the European Commission:

(a) to focus on extending the internal framework of mutual recognition within the EU to include the cross-border delivery of CCP services within the EU; and

(b) to commence a comparable negotiating process with its counterpart authorities in the US (and elsewhere, as may be appropriate) to establish mutual recognition of CCPs.

The suggestion in (b) will also help to rebut allegations of EU protectionism over the Commission’s call for Euro dominated CDSs to be cleared by EU clearing houses. After all, if systemically important institutions are able to deliver cross-border services based on their home state regulation, it is difficult to see why the same cannot be true of CCPs in relation to their central clearing services.

5.7 The FOA notes the Commission’s observation that “market participants have a natural incentive to use CCP clearing, as it reduces their counterparty credit risk and allows regulatory capital savings”, but does not accept the inherent criticism in the conclusion that those “incentives have not been sufficient in overcoming commercial incentives favouring bilateral clearing”. This is to suggest that there are two different competing objectives, namely, (a) the desire to secure regulatory capital savings, which is encouraging some industry participants to use CCP clearing; and (b) the risk management priority of ensuring that exotic transactions, which are not capable of being centrally cleared, are available for hedging exotic risks (i.e. this is more about “risk management” than purely “commercial incentives”). In the view of the FOA, effective risk management capabilities must be the priority and it is actually risk-enhancing to suggest that exotic transactions should be put beyond economic reach or their use should be deterred in some way or that the use of capitalised capital savings should take priority over prudent risk management practice.

5.8 As already stated, the FOA is strongly supportive of making CCP clearing available for use in connection with vanilla OTC contracts, but the subsequent concentration of risk within a CCP should not be underestimated, where, potentially, its default risk is systemically significantly more important than the independent failure of a dealer and this increase in concentration risk will need to be carefully measured and, where possible, mitigated.

**Execution**

5.9 The FOA accepts that there are distinct advantages to on-exchange contacts, but, at the same time, notes the Commission’s recognition that such contract “may not cater for the full range of derivative user’s risk management needs” and that “most market participants have a commercial preference for trading OTC”. Since this is true of most institutional and commercial counterparties, there is therefore a “societal” preference for institutional and corporate counterparties to be able to choose the transactions which best suit their risk management needs and how they are to be executed. As already stated, this was very much one of the underlying objectives of MiFID which, in return for higher levels of commercially sensitive transparency, allowed counterparties to execute their transactions away from the centralised market.

The FOA does not believe that – given that a pragmatic increased level of transparency can be agreed and that there will be comprehensive trade reporting of all bilaterally executed OTC trades to the regulatory authorities – there is any particular reason why OTC execution should be the subject of regulatory intervention. In this context, it is worth noting that, in almost every economic transaction undertaken by both retail and wholesale customers and counterparties, they can choose between trading directly with each other or going to a retail distributor or dealing in an auction or some other market – and this covers a whole variety of sometimes complex physical transactions. This right to determine execution methodology,
which is available in all other economic sectors, should also be freely available in the financial services sector.

Collateral

5.10 The FOA notes and recognises the importance of reviewing and, as may be appropriate, strengthening the bilateral collateralisation of OTC transactions which are not centrally cleared. However, unduly limiting the forms of collateral which are permitted could create problems for some counterparties and result in a significant increase in the costs of risk management for them. For some, collateral is a scarce resource, particularly in the current climate and/or there may be timing problems insofar as a counterparty may be required to provide collateral before it has actually received it from its own customers and/or certain types of collateral will not be readily available to some counterparties (e.g. commodity dealers). An insensitive approach which does not take account of the business profile and asset base of counterparties could result in an increase in the costs of risk management to the point where it is no longer economically viable.

5.11 The FOA supports initiatives by the European Commission to encourage derivatives market participants to increase the frequency of collateral portfolio reconciliations and formalise and improve existing market practices around the area of dispute resolution. In the view of the FOA, a more consistent approach to dispute resolution will contribute the most to systemic risk reduction in the collateral management arena.

5.12 The FOA welcome’s the Commission’s recognition of the “bespoke and flexible nature of OTC derivatives markets” and that the Commission is willing to “further assess” this issue and the “trade off” between the freedom to bilaterally execute transactions and the related objective of securing a higher but “appropriate” level of transparency, which would enable customers to continue to exercise that choice.

6. Conclusion

6.1 The FOA agrees with the statement that “derivatives play an important role in the economy but are associated with certain risks” and that the new framework of more intensive regulation must balance out the need to address those risks while not undermining the economic role of derivatives.

6.2 The FOA believes strongly that it is highly desirable that a global regulatory approach is adopted for what is a global financial service sector and that it is therefore important that the Commission takes into full account the regulatory framework for OTC derivatives that is being developed in the US. However, reflecting the Commission’s earlier observation that derivatives are “important tools for economic agents to transfer risk”, proportionality is paramount and if, as currently appears to be the case, the US decided to adopt an unduly market-restrictive approach to the regulation and use of derivatives, the FOA would urge the Commission to review very carefully the market impact and the consequences for risk management capability of adopting a similar approach in the EU (see Appendices 3 and 4).
APPENDIX 1

LIST OF MEMBERS OF THE FOA
FINANCIAL INSTITUTIONS
ADM Investor Services International Ltd
AMT Futures Limited
Bache Commodities Limited
Bank of America Merrill Lynch
Banca IMI S.p.A.
Barclays Capital
Berkeley Futures Ltd
BGC International
BHF Aktiengesellschaft
BNP Paribas Commodity Futures Limited
Calyon SA
Capital Spreads
Citadel Derivatives Group (Europe) Limited
Citigroup
City Index Limited
CMC Group Plc
Commerzbank AG
Credit Suisse Securities (Europe) Limited
Deutsche Bank AG
Fortis Bank Global Clearing NV - London
Fortis Bank SA/NV – London
GDI Markets Limited
GFI Securities Limited
GFT Global Markets UK Ltd
Goldman Sachs International
HSBC Bank Plc
ICAP Securities Limited
IG Group Holdings Plc
Investec Bank (UK) Limited
JP Morgan Securities Ltd
Liquid Capital Markets Ltd
M & G Investment Management Ltd
Macquarie Bank Limited
Mako Global Derivatives Limited
MF Global
Marex Financial Limited
Mitsubishi UFJ Securities International Plc
Mizuho Securities USA, Inc London
Moncor (London) Ltd
Monument Securities Limited
Morgan Stanley & Co International Limited
Newedge Group (UK Branch)
Nomura International Plc
ODL Securities Limited
Rabobank International
Royal Bank of Canada
Royal Bank of Scotland PLC
S E B Futures
Schneider Trading Associates Limited
S G London
Standard Bank Plc
Starmark Trading Limited
The Bank of Nova Scotia
The Kyte Group Limited
Tradefair
Tullett Prebon (Securities) Ltd
UBS Limited
Wachovia Securities International Limited

EXCHANGE/CLEARING HOUSES
APX Group
Bahrain Financial Exchange
CME Group, Inc.
Dalian Commodity Exchange
Dubai Mercantile Exchange
ECX
EDX London
European Energy Exchange AG
Global Board of Trade Ltd
ICE Futures Europe
LCH.Clearnet Group
MEFF RV
NYSE Liffe
Powernext SA
RTS Stock Exchange
Shanghai Futures Exchange
Singapore Exchange Limited
Singapore Mercantile Exchange
The London Metal Exchange
The South African Futures Exchange
The Tokyo Grain Exchange

SPECIALIST COMMODITY HOUSES
Amalgamated Metal Trading Ltd
Ambarian Commodities Limited
ED & F Man Commodity Advisers Limited
Engelhard International Limited
Glencore Commodities Ltd
Koch Metals Trading Ltd
Metdist Trading Limited
Mitsui Bussan Commodities Limited
Natixis Commodity Markets Limited
Phibro GMBH
RBS Sempra Metals
Sucden Financial Limited
Toyota Tsusho Metals Ltd
Trafigura Derivatives Ltd
Triland Metals Ltd
TRX Futures Ltd

ENERGY COMPANIES
Accord Energy Ltd
Atel Trading AG
BP Oil International Limited
British Energy Trading and Sales Limited
ChevronTexaco
ConocoPhillips Limited
E.ON Trading AG
EDF Energy
EDF Energy Merchants Ltd
Gaselys
International Power plc
National Grid Electricity Transmission Plc
RWE Trading GMBH
Scottish Power Energy Trading Ltd
Scottish & Southern Energy Plc
PROFESSIONAL SERVICE COMPANIES

Allen & Overy LLP
Ashurst
Baker & McKenzie
Barlow Lyde & Gilbert
Berwin Leighton Paisner LLP
BDO Stoy Hayward
Cass Business School
Clifford Chance
Clyde & Co
CMS Cameron McKenna
Complinet
Contango Markets Limited
Deloitte
Denton Wilde Sapte
Eukleia Training Limited
Exchange Consulting Group Ltd
FfastFill
Fidessa Plc
Field Fisher Waterhouse
FOW Ltd
Freshfields Bruckhaus Deringer
Herbert Smith LLP
Hunton & Williams LLP
International Capital Market Association
ION Trading Group
JLT Risk Solutions Ltd
Katten Muchin Rosenman Cornish LLP
KPMG
Morgan Lewis & Bockius LLP
Mpac Consultancy LLP
Norton Rose LLP
Options Industry Council
Patsystems (UK) Ltd
Pekin & Pekin
Pinsent Masons
Rostron Parry Ltd
RTS Realtime Systems Ltd
Simmons & Simmons
SJ Berwin & Company
SunGard Futures Systems
Swiss Futures and Options Association
Travers Smith LLP
Wragge & Co
COMMISSION STAFF WORKING PAPER:
POSSIBLE INITIATIVES TO ENHANCE THE RELIANCE OF OTC DERIVATIVES
MARKETS

FOA Response to “Questions to Stakeholders”
Standardisation

Q1: What would be a valid reason not to use electronic means as a tool for contracts standardisation?

There is a need to clarify what is meant by “standardisation” as there are several different axes along which standardisation might be measured. It is important to note, however, that standardisation does not indicate that a trade is suitable for central clearing as a “standard” contract is not necessarily traded by counterparties eligible for membership of a CCP, liquid enough to support novation of trades in event of default, or conducive of easy risk calculation.

The FOA does not agree that electronic means should be used to enforce product standardisation, i.e. the removal of more bespoke contract options from the market. Many contracts are structured to address the bespoke risks of a given market sector or even a given firm, particularly in commodity markets, and forcing standardisation would adversely impact the ability of such firms to adequately manage risk, leading to incomplete hedging/risk transfer, or alternatively, if the cost for centrally clearing an appropriate standardised contract is too high, to firms electing to retain the risk rather than seek to hedge.

More generally, the cost of electronic standardisation for certain non-standard contracts may outweigh the benefits which might follow. In markets where the potential for quick electronic standardisation exists, firms have recently made significant headway in developing the systems and market infrastructure necessary, and where that development has not taken place there are usually legitimate reasons why such standardisation is not considered appropriate. Primarily, the cost of systems development for the electronic standardisation of niche contracts relative to the risk mitigation benefits.

Standardisation might be more universally beneficial if limited to process and legal uniformity. Process uniformity involves the standardisation of matching and settlement processes, and legal uniformity is the use of recognised, industry standard documentation such as that provided by a number of trade associations. This approach would not limit the range of contracts traded nor the method by which they are cleared, but would generally reduce operational risk.

Q2: Should contracts standardisation be measured by the level of process automation? What other indicators can be used?

Process automation alone can often be an indicator of complexity in a contract rather than one of simplicity leading to potential for standardisation. However, the FOA believes that a range of factors taken together can be indicative of the level of standardisation, including:

- agreed market valuation methodology;
- sufficiently liquid market;
- availability of clearing for contract and/or similar contracts; and
- availability and applicability of industry standard documentation.

Q3: Should non-standardised contracts face higher capital charges for operational risk?

The FOA does not believe that non-standard contracts should incur higher capital charges as a matter of default purely because they are non-standard.
The existing framework for capital calculations under Basel II and the CRD provides multiple avenues for increasing the capital charge on those contracts which are deemed to hold higher risk. Advanced Pillar 1 calculations consider historical loss data from both the firm and the market when determining the appropriate capital charge to cover operational risk, while the basic calculations already incur a higher charge for trading activities.

Moreover, the local regulator has the power to assess and increase the capital charge under Pillar 2 in the event that the risk profile of a firm includes non-standard contracts which the regulator feels increase the risk profile of that firm beyond the level already accounted for under Pillar 1.

Given that two avenues under the existing regime already allow for increased capital charges, but both are more selective than a blanket increase in the capital charge across all non-standard contracts, there appears no justification for replacing nuanced regulation with a one-size-fits-all approach.

Q4: **What other incentives toward standardisation could be used, especially for non-credit institutions?**

The case for standardisation, beyond the limited definition of process and legal uniformity identified above, has not been made. In practice, markets tend towards standardisation as appropriate and recent events have encouraged this process wherever possible, but a lack of standardisation is not, in itself, necessarily a bad thing unless standardisation is both possible and a net benefit to participants in a given market.

Non-credit institutions are most frequently the institutions which benefit least from standardisation at the expense of the ability to manage risk via bespoke products, and incentives towards standardisation are only of use to the extent that they do not act instead as a disincentive to manage risk. In this context, excessive collateral and/or cash margin requirements may result in firms electing to carry the risk rather than transfer it.

**Strengthening bilateral collateral management**

Q5: **How could the coverage of collateralised credit exposures be improved?**

Broadly speaking, this could be achieved by both enhancing the way in which existing collateral is managed and by increasing the range of collateral which is acceptable in certain markets.

Collateral management could be improved by encouraging the use of standardised bilateral netting agreements. Netting agreements themselves are dependent on the harmonisation of the relevant regulations across jurisdictions and while considerable progress has been made within Europe, there is scope to both enhance netting regulation within Europe and encourage other jurisdictions to adopt robust and compatible regimes.

Progress could also be made by encouraging the development of systems necessary to more rapidly redistribute collateral following revaluation of positions and in the event of default, thereby making better use of existing collateral.

At present, the acceptable forms of collateral are limited. Extending the definition of eligible collateral would necessarily increase the total collateral available and increase coverage. For example, the recent Commission reviews of commodity markets revealed that the use of traditional forms of collateral was limited, but that many significant physical market participants were in a position to offer parent company guarantees which were considered...
reliable by other market participants but not recognised by CERS/CEBS as being a legitimate risk management tool.

Q6 Are there markets where daily valuation, exchange of collateral and portfolio reconciliation cannot be the goal? Please justify.

While daily valuation, exchange of collateral and portfolio recognition are reasonable goals in many, indeed most markets, there are certain markets where specific conditions render such aims inappropriate. Typical characteristics might include:

- insufficiently liquid markets to ensure adequate price discovery. Within this category would also be those markets which do not trade frequently enough to render daily valuation meaningful;
- bespoke structured trades which are collateralised on the issue date and do not therefore require daily margining or the exchange of collateral on that basis;
- markets where alternative means of reducing counterparty risk are widely used and have proven effective. For example, parent company guarantees from physical market participants in certain commodity markets; and
- large and/or complex portfolios where precise daily valuation and subsequent margining are not cost effective when measured against reconciliation to within acceptable levels of accuracy.

Q7: How frequently should multilateral netting be used?

The purpose of this question is not entirely clear, but it seems to point towards trade compression.

In general, multilateral netting is a complex process with limited benefit from market participants relative to the cost involved. As such the FOA believes that multilateral netting should be used only as frequently as the firms concerned feel that there is sufficient scope to reduce risk at a reasonable cost by doing so. There is no general benchmark for the frequency with which multilateral netting should be used.

Q8: Should bilateral collateral management be left to self-regulated initiatives or does it need to be incentivised by appropriate legislative instruments?

Basel II and the CRD already provide firms with capital incentives to adopt appropriate risk management approaches, and include indications as to the most appropriate forms of collateral and rules for the recognition of collateral arrangements as a risk mitigant when calculating capital requirements. Firms are required to ensure that all legal agreements pertaining to bilateral collateral arrangements are robust and legally enforceable in the jurisdictions concerned, and additionally to consider the risk to the collateral, the potential delays in recovering collateral from a counterparty and the risk of decline in the value of that collateral over the intervening period.

The FOA is not clear what additional form of incentive would be appropriate beyond the clear advantages of maintaining an adequate collateral management policy provided by the CRD, nor what additional collateral management practices might be encouraged beyond those already covered by the CRD. Insofar as bilateral collateral arrangements reduce counterparty risk exposure and are effectively self-funding, they already provide a significant incentive and this has been reflected in the existing commitment form larger firms to improve the level of collateralisation and the dispute resolution process.
We are opposed to any suggestion that the levels of capital should be adjusted to provide a further incentive beyond that inherent in the direct risk mitigation effects of collateral, either reducing the capital charge for firms using bilateral collateral arrangements or by increasing the charge for firms electing not to use such arrangements.

**Central data repository**

**Q9:** Are there market segments for which a central data repository is not necessary or desirable?

While there are no market segments for which a data repository is not desirable, it is necessary to ensure that the data reporting requirements of any such depository do not impede the introduction of new products to the market.

It is important for regulators to note that some OTC markets lack the necessary process standardisation for firms to easily contribute to a central data repository, and that the timeframe from introducing any such repository should take this into account.

**Q10:** Which regulatory requirements should central data repositories be subject to?

Central data repositories should be subject to strict regulations covering confidentiality and rights of access, with access being available only to appropriate regulatory bodies. The data repositories themselves should function purely as a holding house for data and should have no further power or responsibility to review or disseminate information to regulators, market or the general public.

**Q11:** What information should be disclosed to the public?

Counterparty level data gathered in repositories to enable regulators to better monitor markets should not be made available to the public. Only high level, aggregated data should be made available, which shows overall market movements and not the involvement of individual firms or other market participants.

**CCP clearing**

**Q12:** Do you agree that the eligibility of contracts should be left to CCPs? Which governance arrangements might be necessary for this decision to be left to the CCP’s risk committees?

The eligibility of contracts for clearing should require the agreement of CCPs, but any evaluation process should also involve input from firms.

A CCP’s risk committee is ultimately responsible for evaluating the contract in the light of the CCP’s risk management process and ability to manage a member default. The risk committee must be satisfied that the appropriate margin levels are set and that a default from a member in relation to a given contract could be absorbed by the default fund and the remaining non-defaulting members. It is important to remember here that a CCP does not eliminate risk, only mutualise the impact of one member defaulting among the remaining members, yet it is conceivable that a systemic event involving more than one firm could impact the ability of the CCP to adequately insulate other members from the default.

CCPs are generally for profit entities, usually the subsidiaries of exchanges, which may face pressure to increase income at the expense of sound risk management processes that benefit the wider market at the cost of revenue. For this reason, it is necessary to ensure that the risk committee of a CCP has the final power of veto over any contract. In assessing the eligibility of a contract the committee should seek input from those firms which are existing or potential market participants to determine the appetite for clearing and the
anticipated level of interest in the contract when weighed against the necessary default fund contributions and margin to protect the market from a default.

Q13: **What additional benefits should the CCP provide to secure a broader use of its services?**

The FOA is not clear on the purpose of this question as it should not be the role of the Commission to mandate, or even encourage CCPs to provide additional services in order to increase the use of central clearing within markets. CCPs, as noted previously, are commercial entities and should be free to make service decisions on that basis to the extent that they do not increase risk without suffering a regulatory responsibility to reduce it.

CCPs, together with exchanges, are particularly well placed to assist with post trade transparency reporting requirements and might therefore help alleviate some of the burdens faced by firms. This in itself is unlikely, however, to provide firms with sufficient incentive to clear more trades centrally.

Q14: **Is the zero-risk weighting a sufficiently effective incentive for using CCPs across different market segments?**

While the risk weighting is an incentive where CCP clearing is available for a given contract, it is not sufficient in itself to encourage firms to clear contracts where those contracts are not otherwise suitable for clearing due to the factors already discussed.

Q15: **Should additional requirements, such as appropriate account segregation, be introduced to apply the zero-risk weighting to indirect participants?**

There are a number of models of segregation which could be made available to clients, but each of these has an associated cost, and as such the final decision should be one made by clients after consultation with their dealers. Clients of clearing members should not receive the benefits of zero weighting.

Q16: **Should bilateral clearing of CCP-eligible CDSs be penalised and, if so, to what extent? Is there really a need to extend regulatory incentives to clear through a CCP to other derivatives products?**

As previously noted, the current capital regime already provides sufficient incentive for centrally clearing trades in favour of bilateral arrangement, and the FOA does not believe that capital charges should be amended specifically to encourage and/or penalise behaviour where the result would be a charge that does not align with the real risk of the position.

Where it is possible and beneficial to do so, firms have made significant progress towards central clearing of CDS and other OTC products, yet there are legitimate reasons why certain derivatives products are not well suited for central clearing. Many OTC trades are entered into by commercial clients for the purpose of hedging business risks, and were such trades to be subject to punitive capital charges then the resulting costs to firms would be passed on to clients, directly impacting the end user. The alternative, that firms would seek to reduce capital costs by centrally clearing these contracts, would likewise result in collateral and margin costs for the client firms. Either approach would result in increased costs for the end user and with them the incentive to forgo effective risk management.

Q17: **Under which conditions should exemptions be granted and by whom?**

If no regulatory obligation is imposed on firms, as proposed above, then it follows that no exemptions are required. This approach, as noted, is both flexible enough to accommodate
different markets while allowing scope for product innovation, and consistent with the needs of end users.

In the event that a regime were to impose obligations, then exemptions should fall within the gift of the local regulator so as to ensure that applications could be reviewed by those most directly familiar with the firm, and best placed to observe the subsequent risk profile of the firm and amend the exemptions accordingly on a timely basis if and when necessary.

Q18: What is the minimum acceptable ratio of CCP cleared/eligible contract? What is the maximum acceptable number of non-eligible contracts?

While we support the notion that the regulators should encourage CCP clearing of applicable trades, the FOA believes it is neither necessary nor appropriate to set arbitrary limits, especially those based on ratios, in this matter. The emphasis should instead be on ensuring that the risk associated with non-eligible contracts is managed appropriately regardless of how many contracts of each type a given firm has.

Artificially restricting the ratio of CCP eligible to non-eligible contracts is likely to stifle the development of new products and hinder the ability of firms to hedge risks appropriately, thereby increasing the overall level of risk in the financial system rather than reducing it, and doing so at the cost of innovation.

Q19: What statistics need to be provided to regulators to make sure they have all the information necessary to perform their duties?

This is, to a great extent, a question for the regulators themselves to answer.

Q20: How could European legislation help ensuring safety, soundness and a level playing field between CCPs?

There are a number of measures which could be taken involving the practical operation of individual CCPs and the general regulatory environment in which they operate.

On a practical level, legislation should enforce the necessary governance practices to ensure that CCPs maintain adequate minimum margin levels. As noted above, most CCPs operate as for profit entities, and the pressure to increase market share by offering relatively low margin levels is strong. Similarly, default fund levels should be subject to regulatory guidelines and stress testing to ensure that the CCP can indeed prevent the spread of systemic risk. However, CCPs should still have the scope to vary margin and default fund levels where it can be demonstrated that the particular contracts or markets concerned are subject to lower levels of systemic risk or volatility, or where appropriate supplementary risk management practices are in place.

The broader regulatory environment covering CCPs should seek to ensure that there is no opportunity for regulatory arbitrage between different CCPs within Europe, and ideally between European CCPs and those in other, non-European jurisdictions.

Transparency requirements

Q21: Should MiFID-style pre- and post-trade transparency rules be extended to non-equities products? Are there means to ensure transparency?

The principle advantage of transparency is to improve price discovery, which can generally be regarded as an advantage to any market, although experience in equities markets post-MiFID indicates that greater transparency may hinder liquidity, especially for larger trades.
For OTC trades on behalf of commercial firms, or as a consequence of dealing with commercial firms, post-trade transparency can provide other market participants with sufficient information to identify the holders of significant positions as a result of the bespoke nature of trades and the relatively limited number of market participant. This risk is most evident in certain OTC commodity markets. Care should therefore be taken to ensure that transparency is not encouraged at the expense of confidentiality in all cases.

OTC transactions are generally undertaken by more experienced professional investors with a greater understanding of the market and for whom price transparency is less of a concern than liquidity.

In either case, for OTC or ETD, transparency should not come at the expense of damaging markets or of exposing individual market participants to unnecessary disclosure requirements which might place them at a disadvantage. Careful cost/benefit analysis of different markets should be undertaken before any decision is made, and no blanket policy should be adopted which fails to take into account the impact of a policy on specific markets.

Q22: How should transaction reporting of OTC derivatives to competent authorities be envisaged? Should it be extended to all contracts or to certain categories? If so, which ones? Are there other means to ensure that the competent authorities receive the relevant information on OTC derivatives transactions?

In principle, all post trade OTC data should be available to regulators on a timely, albeit not real time basis. The most practical method of providing this data would be via the previously discussed data repositories, allowing different regional regulators access to the same data without requiring individual firms to complete multiple transaction reports. For the same reason, the number of repositories should be limited. Harmonisation of data reporting formats across different repositories is also a priority.

Data provided should be at a high enough level to allow regulators to identify trends and both firms and counterparties with significant positions. Individual transaction data would not be necessary for data repositories, but should be available for regulators on request, with controls in place to ensure that any such request pertains to a genuine situation where additional data is required, and cannot be made as part of a general exercise to increase the level of data available to the regulator for no immediate further purpose.

The key advantage of the data repository system for firms is the elimination of multiple data requests, which increase costs for firms significantly and, on a practical level, often engage the time of staff who could be focusing on other, more essential compliance and monitoring functions. An alternative to a central data repository, therefore, which could also work in conjunction with such repositories, would be to enhance communication between different regional regulators, enabling regulators to directly request and provide information without the need to request data from individual firms. Controls would be necessary to ensure that all data requests were appropriate and that a regulator could not divulge information not directly pertinent to a request made by another regulator.

Q23: How should position reporting of derivatives to competent authorities be envisaged? Should it be extended to all contracts or to certain categories? If so, which ones? Are there other means to ensure that the competent authorities receive the relevant information on the exposures to particular contracts?

As above, reporting to regulators should be via a central data repository on a post-execution basis. Insofar as position reporting enables regulators to understand the net risk profile of firms, positions on all contracts should be available for regulatory scrutiny, although initial
data need only be provided at a high level, with additional data available on request when appropriate.

We note that the purpose of position reporting greatly influences the scope and design of the report itself. Reports intended to assist with, for example, systemic risk monitoring are likely to be quite different from those intended to aid in the detection of market misconduct. On that basis it is difficult to provide a more extensive answer without understanding the regulatory aims of such reports.

Public trading venues

Q24: How can further trade flow be channelled through transparent and efficient trading venues? What would be the appropriate level of transparency (price, transaction, position) for the different derivatives markets?

In general, the market is increasingly moving towards electronic trading venues, which offer a high degree of transparency and efficiency. As noted above, where such venues are appropriate for the contracts concerned, market participants do not require further incentives, and where participants appear reluctant this is because of underlying incompatibilities between the products and the venues available.

Appropriate levels of disclosure necessarily vary between markets, with the most obvious divide being between financial and commodity derivatives, but even within those two broader groups the specifics of a given market require careful adjudication before an answer can be given.
EXPLANATORY MEMORANDUM ON DERIVATIVES MARKETS

Drafted by FOA, ISDA and FESE and produced for the European Parliamentary Financial Services Forum (EPFSF)
Derivatives Markets

Introduction

“Derivatives” is a term used to describe a range of financial instruments whose primary role is to provide commercial users and institutional investors with a means of “hedging” or protecting themselves from future negative price movements across a range of exposures, including particularly in equities, bonds, credit, commodities, currencies and interest rates and indices. Their value is generally based on, or derived from, the price of one or more underlying assets, rates or indices and, unlike the case with physical dealings which result in the physical delivery of the underlyling product, the vast majority of derivatives are cash settled.

Using derivatives to control price risk has been an integral part of trade in commodities worldwide for centuries. Their emergence was generated by the need to develop some form of price certainty in the face of sudden fluctuations in commodity prices caused by, for example, irregular or cyclical production, changing weather patterns or political instability. Growth in their popularity led to the establishment, for certain products, of centrally regulated markets or exchanges for the trading of standardised derivatives to better access prices, information and counterparties. The dismantling of Bretton Woods, which led to the privatisation of the process of stabilising money rates, resulted in derivatives being extended to cover the raw material of the financial world, namely, money and financial instruments.

Uses

- **Hedging**: The proliferation of derivatives worldwide has meant that organisations are now able to hedge their positions in most of the world’s capital and money markets in the world’s most traded commodities. Financiers and borrowers can fix the cost of lending/borrowing money; importers and exporters can protect themselves from adverse movements in exchange rates; producers can lock in their profits; factories can to hedge against sudden rises in the cost of manufacture; lenders can hedge concentrations of credit risk; and farmers and growers are able to protect their budgeted farm profits. At the same time, managers of equity funds or individual portfolios can hedge against sudden fluctuations in the value of securities by taking positions in individual stock options or derivatives based on stock indices and/or undertake a whole range of investment strategies in diversified markets not otherwise available to them.

At its simplest, a hedge is put on by taking a position in a derivative instrument that is equal and opposite in price sensitivity to an underlying cash or physical position or money rate, such that losses in the underlying position will be offset by a commensurate gain in the derivatives position. The process may involve “going short” the price of the underlying (where the object is to protect an existing position) or “going long” (where the object is to protect an anticipated physical position). Of course, by taking such a position, the hedger gives up the opportunity of benefitting from any additional unforeseen profits in the underlying position, but the primary concern of the hedger is to protect budgeted profit margins by using derivatives to become secure as to price and profit if the market moves against the underlying position.

Today, derivatives markets are used by a wide variety of businesses around the world to predict prices and to deliver price assurance and business stability. In the retail sector, their use has facilitated the development of fixed rate mortgages for homeowners, more stable retail prices for foodstuffs and, for the consuming public, interest-free credit.

- **Trading and Investment**: While the vast majority of market participants use derivatives as risk management / transfer instruments, some financial institutions and traders also use them for trading on price and, while this has sometimes come under criticism, particularly in commodity markets, these non-commercial traders play a fundamentally important role in sustaining high levels of market liquidity and taking the other side of the hedging positions of commercial market participants. This is because the trading motivation of a physical market participant is simply to protect trade profits, whereas the financial market participant is looking to secure a profit on anticipated price movements or to diversify portfolios.

Characteristics

1 94% of top companies, according to a recent ISDA survey
Whether derivatives are traded OTC or on a central regulated exchange or some other execution platform, they all have a number of unique and shared characteristics:

- The ability to hedge/profit in falling as well as rising markets;
- The existence of a wide product range;
- Deep, liquid markets in the benchmark contracts;
- The ability to create immediate exposure quickly and often at low cost;
- Contracts can be traded on payment of a small proportion only of the total price exposure afforded by the contract (i.e. leverage or gearing);
- Provision of a mechanism for formulating a view on forward prices over a chosen timeline.
- Targeted risk transfer through the blending of different derivative products covering different underlyings (e.g. bonds risk, credit risk, currency risk, etc.)

**Types of Instruments**

Derivatives cover a very broad range of contracts and generally fall into three principal categories, each of which may at the agreement of the parties be cash-settled (sometimes referred to as settled ‘for differences’) or physically settled:

- **Futures (often called in the OTC markets “forwards”):** Agreements to buy or sell a commodity, financial instrument or other underlying property for an agreed price, but with delivery taking place on a specified date or range of dates in the future.

- **Options:** Agreements under which one party (i.e. the purchaser) acquires the right (but not the obligation) to buy (in the case of a “call option”) or sell (a “put option”) a commodity, financial instrument or other underlying property (including other derivatives) at a price (the “strike price”) agreed at the time of the agreement (including an additional payment or “premium” for that right). The seller (or “writer”) of an option is under a contractual obligation to effect delivery at the strike price, but only at the election of the buyer who may decide either to “exercise” the option or to “abandon” it in the event it has no intrinsic value.

- **Swaps:** Agreements to exchange a series of cash-flows determined by reference to an underlying instrument, product, index or notional amount (e.g. a fixed rate of interest versus a floating rate). These are part of a category of product called “contracts for differences” because the underlying product (whether exchange traded or OTC) is not capable for delivery other than by way of a cash settlement. Swaps are sufficiently distinctive and their use sufficiently wide to merit being categorised separately.

**Types of Markets**

The derivatives market is a global market where competition takes place across multiple geographical regions, execution venues and methodologies and products. They may be traded “on-exchange”, i.e. on a “regulated market” (or some other regulated multi-lateral trading facility) or off-exchange (otherwise known as over-the-counter (OTC)). The choice of market will depend upon the underlying needs of the counterparties and the prevailing liquidity of the market in question.

[It is difficult to evaluate relative size of on-exchange and OTC derivatives markets due to a lack of common statistical indicators, but the December 2008 figures of the Bank for International Settlements show a notional amount for financial instruments traded on organised exchanges of around USD 60 trillion. In addition, 1,684 million commodity contracts were traded on-exchange in 20072. While gross cumulative turnover in OTC derivatives (i.e., before economic offsets) totals around USD 591 trillion, the real risk is considerably less. After netting, the market value of these contracts is USD 34 trillion – and that is before collateralisation.

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The **OTC markets** are essentially wholesale professional markets (e.g. the precious metals, or bullion, market, the foreign exchange market, the oil market, the interest rate and currency swaps market, the equity and credit markets), in which derivative contracts are traded bilaterally between banks, other financial institutions and large corporate organisations, often in large size. Most OTC contracts are comparatively straightforward and resemble exchange-traded contracts, but there is no requirement that they be fungible (i.e. interchangeable), meaning that others can be very specifically tailored (which in some cases leads to challenges in valuation\(^3\)). They offer certain additional advantages:

- they can be tailored to meet the individual needs of the parties (thereby reducing “basis risk” or the risk that the hedging instrument is not precisely matched to the underlying asset or exposure);
- they enable organisations to access commodities, instruments and/or maturities/delivery dates that are not available on an exchange;
- they enable organisations to choose their own counterparties and their own methodology for managing credit risk (including close-out netting and collateralisation or margin arrangements);
- while the market place is not itself directly regulated, dealings are executed with regulated firms:
- some OTC contracts are significantly more liquid than their exchange-traded counterparts (and, in some cases, the entire liquidity in a particular instrument can only be found off-exchange, such as the foreign exchange market).

**Exchange-traded** contracts are fully standardised contracts executed in regulated wholesale professional markets and cleared by regulated clearing houses. As such, they offer other additional advantages:

- Exchanges are centrally-regulated markets which are supervised by the relevant national authority; and regulators have a complete view of market players and risk taken.
- Dealings are in standardised products which enable buyers and sellers to trade multi-laterally and to open and close positions easily in a liquid market;
- Dealings are supported by a clearing house guarantee, which assumes and reduces therefore the counterparty risk of each buyer and seller; A market participant therefore no longer needs to look at the risk from different other market participants but is only exposed to the CCP itself and its risk management processes.
- Contracts are recorded and published in real time and supported by a transparent price formation and discovery mechanism, automated risk reducing trade processing and transparent post-trade process regime offered by the clearing house.
- The risk of loss is covered by daily “margin” payments set by the clearing house (i.e. a deposit based on a percentage of the full contract value and calculated daily according to historic/possible market movement).

Growing convergence across products, increasing standardisation and the complementary nature of the different markets has resulted in some exchanges looking to offer non-standardised instruments. Others are providing a wide range of “back office” and clearing services to OTC dealers, such as valuation and management services in relation to collateral. At the same time, OTC derivatives are traded using standardised documentation (and this is being extended rapidly to new products) and, in some cases, trade on margin; and will, where possible, be centrally cleared by a clearing house.

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\(^3\) OTC contracts should not be confused with the situation where an exchange’s contracts may be traded out of hours or over the telephone, because the latter are still traded and cleared under the rules of the relevant exchange.
RELEVANT FOA PRESS RELEASES
FOA warns against regulating customer choice and product diversity out of exchange and OTC markets

London, Friday 15th May 2009: The Futures and Options Association (FOA) welcomes Treasury Secretary Timothy Geithner’s call for closer supervision of over-the-counter markets. It recognises that they will have to be subject to more comprehensive transaction reporting requirements to regulators and that standardised OTC transactions will increasingly be encouraged to become cleared by CCPs. To this extent, the proposals of the Treasury Secretary are consistent with overall global thinking.

However, the conclusion that these proposals will enhance competition between OTC markets and regulated exchanges is difficult to reconcile with the regulatory pressure that will be brought to bear to:

- move the execution of standardised OTC transactions onto regulated exchanges, and
- encourage regulated financial institutions to use exchange-traded derivatives.

“This kind of regulatory pressure will distort free market competition and restrict product diversity,” said FOA chief executive Anthony Belchambers. "It provides a good example of the need for market proportionality and for better transatlantic co-operation to avoid needless regulatory arbitrage. The question of execution is not the issue here and should not be a matter for regulatory action without proper justification.”

FOA does not support the use of regulation to incentivise or disincentivise the use of particular markets. While greater supervision is inevitable, it is also important to maintain differentiation and execution choice in market structures.

OTC markets are a valuable breeding ground for exchange products and a large proportion of exchange volumes are derived from OTC markets laying off risk onto exchanges. Exchanges and CCPs are already providing services to the OTC market and have made significant steps in enhancing efficiency and facilitating post-trade transparency as a result of competitive initiatives rather than regulatory-driven intervention.

FOA strongly supports the right of customers to choose their preferred products and trade in their preferred markets and to use products that are appropriate to the risk profile of their businesses. On balance, therefore, while there is much that is positive in Secretary Geithner’s proposals, which accord with EU thinking, FOA does not agree to regulatory pressure that restricts customers’ choice in wholesale markets.

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FOA welcomes the European Commission’s recognition of the “bespoke and flexible” nature of the OTC markets in today’s Communication “Ensuring efficient, safe and sound derivatives markets”.

3rd July 2009: The Futures and Options Association (FOA) supports the drive to improve regulatory oversight, deliver greater operational efficiencies and secure more comprehensive trade reporting requirements in relation to dealings in the OTC markets. It particularly welcomes the commitment to continue to work constructively with the industry towards securing a CCP solution for clearing standardised OTC transactions and strengthening counterparty risk management in bilateral OTC trades which are not eligible to be centrally cleared.

In the recent debate about OTC execution, it should be remembered that MiFID, in relation to cash equities, abolished the “concentration” rule (whereby transactions were required to be executed on a central exchange) and allowed customers, in return for increased transparency, to choose for themselves whether they wished to trade on a regulated exchange, an MTF or bilaterally with their preferred dealers. Consumers have always had this freedom across the whole range of their economic activities and there is no reason why, against the background of much closer market oversight, they should not continue to be able to exercise that right as regards OTC transactions.

Anthony Belchambers, Chief Executive, said “The Communication emphasises that derivatives are an important tool for economic agents to transfer risk and it is essential, therefore, that this programme for regulatory repair, while totally necessary and understandable, does not impair the ability of OTC markets to meet that functional responsibility. It is worth noting that the drive to secure CCP clearing in OTC markets had already commenced before the current financial crisis – a momentum that was driven by the industry of its own volition. Moreover, it has always been open to customers and counterparties to enjoy the benefits of greater transparency and central regulation by executing, where possible, their risk management transactions on exchange. The lessons of the crisis have made market users more aware of the importance of adding these values to their trading activities.”

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FOA OBSERVATIONS ON THE STATEMENT OF GARY GENSLER (4/6/09)
FOA Comments

Possible Consequences and Issues

While there is much to support in his Statement, and there is a very clear need to enhance supervision and increase the safety of the OTC markets, the speech also raises number of concerns, namely:

- In stating that the new comprehensive regulatory framework “should apply regardless of whether the derivatives are standardised or customised” and “no matter what type of derivative is traded or marketed”, there is no mention of the need for a risk-based approach and no recognition of market or product differentiation or acceptable market practices (which may vary, for example, as between commodity derivatives and financial derivatives and their providers).

- The statement that “all derivative dealers should be subject to “initial margining requirements” (penultimate paragraph on page 2) raises questions over, in the case of bilaterally-traded deals, who is to set those margin requirements and how they will be calculated, particularly relevant for highly tailored products. Will it be the dealers who will assess margin based on their own judgment of the risk of the transaction or will it be set by a (competing!) clearing house?

- In commenting on “capital and margin requirements” on page 3 in the last paragraph, the statement is made that “aggregated information on positions and trades” will be required to be made “available to the public”. While this is helpful, no specific mention is made of preserving customer trading confidentiality (although it is, to some extent, implied).

- With regard to the question of clearing OTC derivative transactions and the role of clearing houses / exchanges, the speech is less than clear, e.g.:
  - “We should require that all derivatives that can be moved into central clearing be required to be cleared through regulated central clearing houses” and “there should be a presumption that if an instrument is accepted for clearing by a fully regulated clearing house, then it should require to be cleared”. There is no qualification of cost so that, for example, a clearing house may be able to clear a highly tailored or illiquid transaction by setting an uneconomically high margin call – but it would not be open to a dealer to use some other form of effective bi-lateral credit risk mitigation (increasing the hedging costs for customers, potentially very significantly);
  - “There should be sufficient product standardisation so OTC derivative trades and open positions are fungible and can be transferred…”, but what does “should” mean and how far will this obligation be taken in terms of squeezing out of the market tailored transactions not capable of being standardised;
The original Geithner letter (13/6) stated that “if an OTC derivative is accepted for clearing by one or more fully regulated CCB’s it should create a presumption that it is a standardised contract and thus required to be cleared”. This is clearly putting the “cart before the horse” insofar as if the contract is accepted for clearing and is the subject of a high margin call, precisely because it is not a standardised product, it should not be deemed to be standardised! Unfortunately this view is emphasised, albeit in different language, in the Gensler speech in which he states that establishing “objective criteria for regulators to determine whether, in fact, a swap is standardised, would include “a presumption that if an instrument is accepted for clearing by a fully regulated clearing house, then it should be required to be cleared”. The cost and risk implications of this kind of analysis could be significant.

- With regard to the requirement that any transaction which is capable of being cleared by a clearing house must also be executed on a regulated exchange or some other “regulated electronic trading system” for execution raises also a number of questions/concerns:
  - The clearing test as to what is or is not standardised could mean that the obligation regarding execution could go way beyond what is understood by the term standardised contract and include illiquid and tailored transactions
  - Does the phrase “regulated electronic trading system” cover all forms of bilateral dealing/voice broking systems or is it really intended to be restricted to regulated multi-lateral trading systems, i.e. lookalike exchanges?
  - To what extent will this obligation undermine the execution business model of dealers?
  - Since, in many jurisdictions, clearing is “silod” within an exchange, the question arises as to whether “silod” clearing facilities will be made available to rival platforms or whether exchanges will expect any contract cleared by them to be executed on their exchange. Depending on the outcome, the optionality of using an alternative regulated electronic trading system may not be readily available.

- In the indicators set out on page 6, no mention is made of the cost of clearing.

- With regard to the prospect of deals migrating to overseas markets, Gensler states that the CFTC must be empowered to “ensure that traders are not able to avoid position limits in a market by moving to a related exchange or market” and on page 8 this is enlarged by the statement that “The Congress should also provide the CFTC with clear statutory authority to ensure the traders that are trading on a foreign board of trade through trading terminals in the US comply with the same US position limits and reporting requirements when trading a foreign contract that settles against any price of a contract traded on a US exchange.”

The possibility of US position limits becoming significantly tighter to the point where they will not be acceptable in non-US markets cannot be too quickly discounted, e.g.

- Gensler has promised to review the impact of speculative trading and commodity markets and US position limits;
- Expected increases in commodity prices, particularly oil, may generate the imposition of tighter position limits with a more restrictive hedging exemption;
- The underlying objective is to prevent traders in the US from being able “to avoid US position limits or reporting requirements by moving their trades onto a foreign exchange” and if the limits are not seen to be fulfilling this objective, they could either
become more restrictive or the core precondition of settling against a US price could be removed to widen the number of non-US contracts captured by US limits.

These risks may mean that exchanges will be reluctant to settle any of their contracts against the price of a contract traded on a US exchange in order to avoid being subjected to US extra-territorial rules and restricting the trading capability of non-US broker-dealers or non-US customers dealing in non-US markets.