

MiFID and OTC derivatives markets: A buy-side perspective

6 December 2011

Safe, efficient OTC derivative markets

What have ISDA and Industry achieved?

- Documentation – ISDA Master Agreement
- Netting and Collateral – Reduction of OTC derivatives credit exposure to approximately 0.6% of notional amount
- Industry Infrastructure – Electronic confirmation and automation
- Compression - have reduced the CDS market in excess of 75%
- Clearing – 50% of Interest Rate Swaps now cleared
- Trade Repositories – credit, rates, equities, commodities
- Interface with global regulators and supervisors

Representing buy-side interests

ISDA continues to embrace and support the buy-side community

- Buy-side firm representation on ISDA Board
- Buy-side firm representation and participation in several industry-led forums, including
 - Industry Governance Committee (IIGC)
 - Industry Clearing Committee (ICC)
 - ISDA Determinations Committees (DC)

ISDA is taking concrete steps to better serve the buy-side in issues relating to OTC derivatives, by:

- Forming a Buy-Side Board Committee;
- Forming a Buy-Side Advisory Group; and
- Dedicating more resources to address buy-side specific needs

MiFID Context

- MiFID I (November 2007): Objective to increase competition and improve investor protection: focus on retail equity markets
- MiFID II: Objective to address consequences of MiFID I. Also responds to crisis – more fundamental rethink of market structure? Transposition of equities rules into OTC markets...
- Components of the review: Market structures; pre- and post-trade transparency; data consolidation; commodity derivatives markets; transaction reporting; investor protection; supervisory powers

The trading obligation

- September 2009 G20 commitment: “All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate...”
- MiFIR: “clearing eligible and sufficiently liquid” derivatives must trade on an organized venue. Note role of European Securities and Markets Authority (ESMA)
- Where it applies, you will have to trade on an Organised Trading Facility (OTF), Multilateral Trading Facility (MTF) or regulated market
- OTF is a new concept: allows operator additional discretion over order handling, but carries with it a ban on OTF operators using proprietary capital to execute client orders – ruling out Single Dealer Platforms from the OTF category

Public transparency

Pre-trade

- There will be a continuous public quoting requirement – venues will have to make public prices and the depth of trading interests on a continuous basis during normal trading hours
- Power for national regulators to waive the requirements for less liquid markets

Post-trade

- Public reporting obligations apply to anything reported to a trade repository
- Detailed calibration – including delays and volume masking provisions – left to Level 2 standards

Systematic Internalization

- Systematic Internalizers are investment firms which “on an organised, frequent and systematic basis, deals on own account by executing client orders outside a regulated market or an MTF or an OTF.”
- “Occasional, ad hoc and irregular” activity is not subject to systematic internalization rules
- SI will be under an obligation to share the quotes it makes to you with all its other clients on a firm basis and to publish the quote to the market (up to a pre-defined size to be determined by ESMA)

Investor Protection

The proposed reform addresses five major issues*

- Classification of complex products
- Inducements
- The basis of pre-sale investment advice
- Post-sale (or on-going) investment advice
- Classification of investors

* There is a sixth issue relating to telephone recordings (primarily a concern for certain retail banks in countries where retail investors place orders via telephone without written confirmation, notably Germany and Austria)

Complex products and Inducements

Complex Products

- Limitation of the scope of financial instruments subject to 'execution only' rules: exclusion of structured UCITS and of any equity, bond or monetary instruments which embed a derivative or incorporate a structure which makes it difficult for the client to understand the risk involved

Inducements

- Abolition of summary disclosure: full ex-ante disclosure will become mandatory
- Introduction of ex-post- reporting
- Ban in the case of portfolio management and independent advice

Investment advice

Basis of investment advice

- Disclosure: Is the advice given on the basis on an independent and fair analysis?
- If so, the investment firm must propose a range of financial instruments available in the market; inducements are banned

Post-sale (or on-going) investment advice

- Six monthly reporting about the market value, the performance of the products, and any material modification in the situation of the product
- Must ask the investor to update the information concerning his personal situation on a yearly basis
- Obligation to check, at least on an annual basis, whether the products are still suitable for the investor

Classification of investors

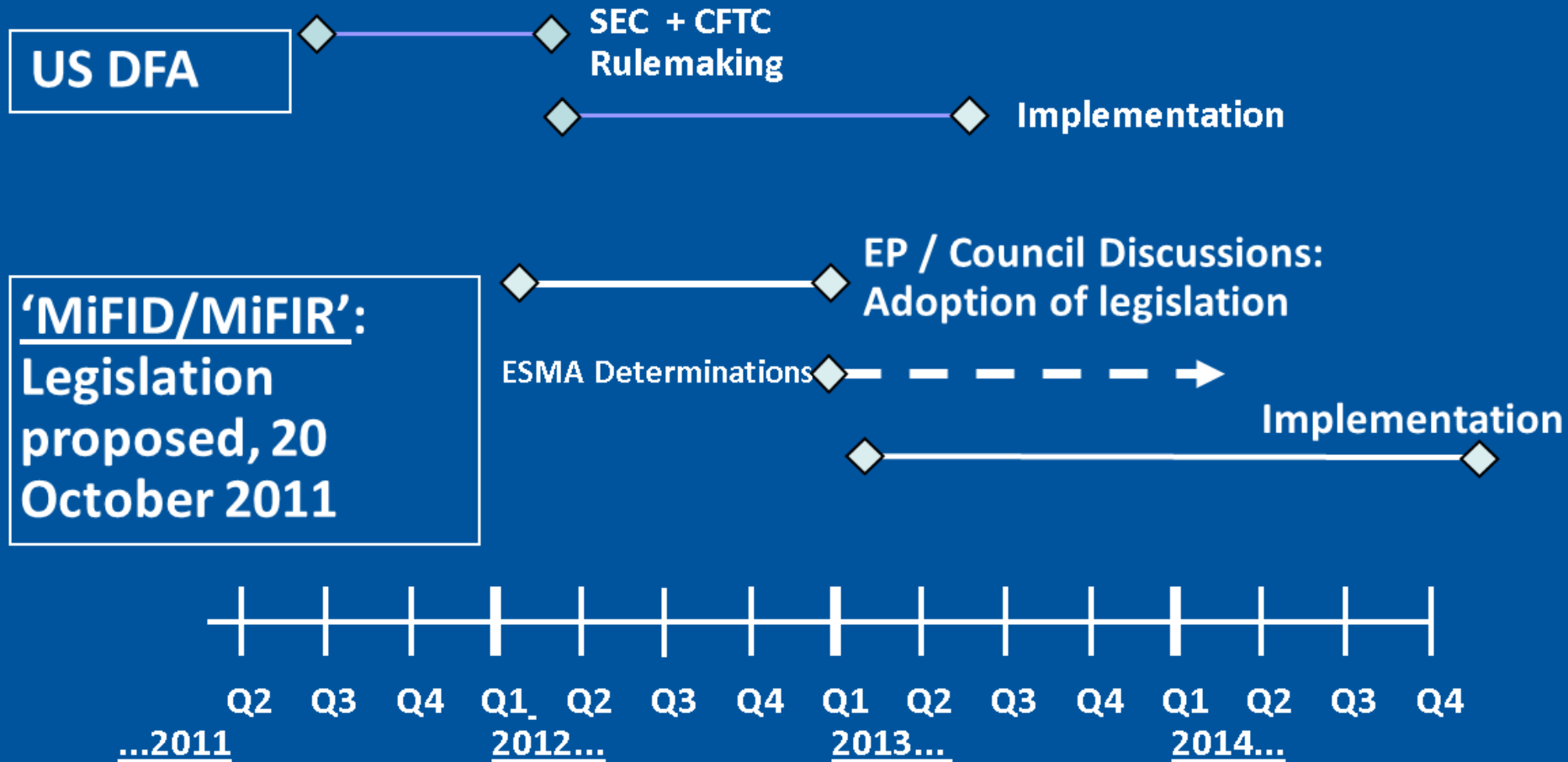
- Principle of acting honestly, fairly and professionally would apply in relationships with eligible counterparties
- The presumption that professional clients have the necessary level of experience and knowledge would be limited to less complex instruments
- Exclusion of municipalities from categories of eligible counterparties and professional clients

European political set-up

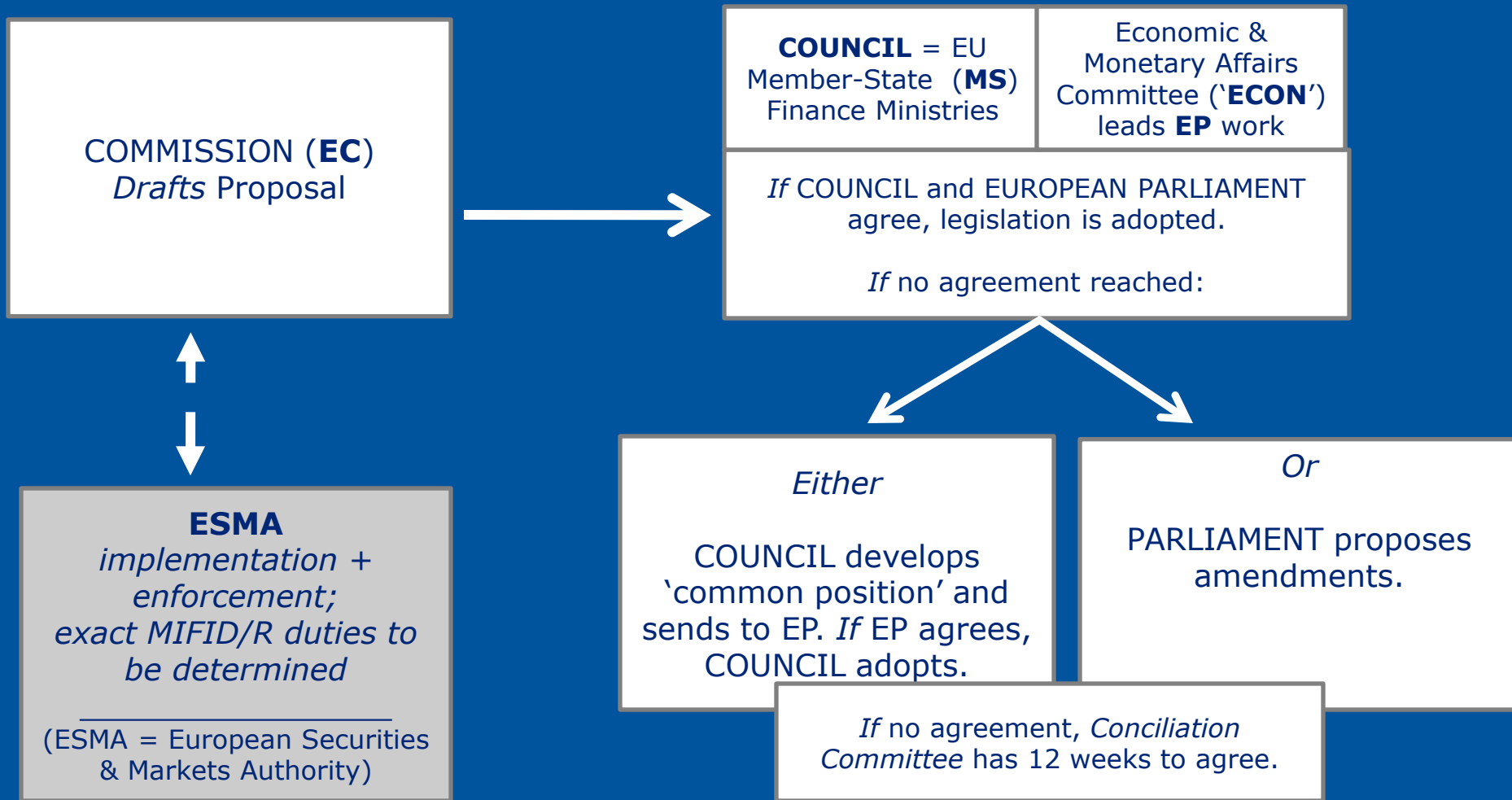


- The **European Commission** is the executive body of the European Union and is appointed for a five-year term by the Council in agreement with the Member States. The current European Commission will be in power from 2009 up to 2014. It **operates like a cabinet government**, with 27 Commissioners - one per Member State. It represents the interests of the EU as a whole.
- The **Council of the European Union** composed of **ministers of the Member States**.
- The **European Parliament** . Members of the European Parliament (**MEPs**) are elected **every five years** in EU-wide elections. The elected MEPs align themselves with a **political group** focusing on EU-wide issues, rather than merely representing the people of the constituencies within individual Member States that elected them.

EU legislative timeline: MiFID vs. Dodd-Frank



EU legislative procedure



Advocacy strategy

- All politics are local
 - EU-wide network of regulators, associations, firms;
 - Map & assess opportunities arising from diff' priorities of MS;
- Appropriate audience-specific presentation
 - Tailor level of detail for Council, EP, EC etc.
- Data and evidence
 - Leverage ISDA and member resources (we need your help!)
- Coordinate and cooperate/avoid duplication with other associations
 - AFME, ICMA, EFAMA, EBF, EACT, AIMA etc...
- Understand & communicate concerns of all parts of derivatives business
- Be realistic about the political context.

Conclusions

Where are we trying to get to?

- More accommodating market structure rules to preserve end user choice
- Transparency rules that work for the users of the OTC derivatives market
- Investor protection rules that are appropriate for the market in question

How can you help?

- Join the debate! Take part in ISDA's educational efforts or speak directly with policymakers in your Member State
- Involvement in other policy issues: Data to show impact on buy-side of Financial Transactions Tax (contact: acorbi@isda.org)

Question and Answers

* Please submit questions via the web event portal *

Panel:

Stephen O'Connor, Chairman, ISDA

Nick Cox, COO Global Trading Management, BlackRock

George Handjinicolaou, Deputy CEO and Head of Europe, ISDA

Richard Metcalfe, Global Head of Policy, ISDA

Roger Cogan, Senior Director of European Policy, ISDA

Benoît Gourisse, Director of European Policy, ISDA

Adam Jacobs, Assistant Director, European Regulatory Team, ISDA