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ISDA's response to the European Commission's Public Consultation on the Review of the Markets in Financial Instruments Directive (MiFID)

On behalf of our Members, ISDA welcomes the Commission's commitment to review MiFID in light of changing market practices and technological developments in order to ensure that all types of trading venues are appropriately regulated.

We believe that any changes to the MiFID regime should respect the flexibility and choice promoted by the current regime, which has delivered clear benefits to consumers and market participants alike. This is particularly important in the context of proposals to introduce a new category of trading venue in the form of OTFs.

Indeed, it is important to appreciate that cash, future, and OTC derivatives markets are complementary – they interact with each other and provide investors with a diverse choice based on their risk management or investment needs; the existence of an organized market for a given product does not necessarily imply greater efficiency relative to an over-the-counter market in tailored products. Any changes to the MiFID regime should help support, rather than detract from, the existing diversity of execution models.

ISDA, which represents participants in the privately negotiated derivatives industry, is among the world's largest global financial trade associations as measured by number of member firms. ISDA was chartered in 1985, and today has 800 member institutions from 54 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities.

Since its inception, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business. Among its most notable accomplishments are: developing the ISDA Master Agreement; publishing a wide range of related documentation materials and instruments covering a variety of transaction types; producing

legal opinions on the enforceability of netting and collateral arrangements (available only to ISDA members); securing recognition of the risk-reducing effects of netting in determining capital requirements; promoting sound risk management practices, and advancing the understanding and treatment of derivatives and risk management from public policy and regulatory capital perspectives.

Yours faithfully,

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[1] ISDA is registered with the European Commission as an interest representative under identification number 46643241096-93. We consent to the publication of this response.

HIGH-LEVEL SUMMARY OF ISDA's POSITION

MARKET STRUCTURE

- We strongly support the existing flexibility and choice provided by MiFID. The introduction of a new trading venue in the form of OTFs should not compromise this choice. The OTF regime must therefore:
  - be clearly defined to give market participants certainty about what it covers; and
  - provide a suitable degree of flexibility to ensure that the value that derives from the existing diversity of execution models is not lost.
- [T]he assessment of whether a derivative is suitable for trading on a particular trading venue should be made separately to the assessment of its eligibility for central clearing.
- It is essential to bear in mind that derivatives trade far less frequently than securities, such that many products will not be suitable for trading on a particular venue.
- The risks associated with the requirement to trade on a particular venue (whether regulated market, MTF, or organised trading facility) will depend on the criteria associated with that venue. For example, an effective OTF regime will need to be able to accommodate a diverse range of execution models, without compromising the flexibility that currently exists.
- [T]he existence of an organized market for a given product does not necessarily imply greater efficiency relative to an over-the-counter market in tailored products

PRE- AND POST-TRADE TRANSPARENCY

- The introduction of a prescriptive pre-trade transparency regime could well undermine the functioning of [OTC derivatives] markets, given that there would be a disincentive for liquidity providers to publish prices, particularly on more illiquid products.
- As for post-trade transparency, we support the development of a formal regulatory regime, as long as it is sensitive to the nature of the market, with time delays and size-related thresholds

DATA CONSOLIDATION

- [T]he less liquid and the more tailored the non-equity product, the less value (and more cost) there will be in a consolidated tape.

COMMODITY DERIVATIVE MARKETS

- [W]e would urge the Commission to ensure that whatever reporting and transparency arrangements are proposed, that these are harmonised with other initiatives such as EMIR and the MAD review, as well as the DG Energy REMIT proposal.
- We appreciate the arguments in favour of amending the exemptions, but are of the view that any practical attempt at such should not be made unless and until the consequences of bringing additional firms within scope of MiFID are more fully understood;

TRANSACTION REPORTING

- We believe that transaction reports provide a useful mechanism for monitoring securities and securities derivatives markets. For commodities, foreign exchange and interest rate derivatives, the risk of abuse relates to market manipulation and we therefore believe that position reports collected by exchanges are the appropriate tool for supervisory oversight

INVESTOR PROTECTION

- We strongly support CESR's proposals for strengthening the right of investors to request information. It is vital to ensure that investors are able to obtain the information that they require to evaluate an investment and to gauge whether to retain it.
- We do not believe that client categorisation rules need to be changed in relation to product types. A false link is sometimes made between product complexity and product risk, which leads to the illusion that complex instruments are automatically high-risk instruments.
- [T]he current presumption of professional clients' knowledge and experience should be retained for all purposes.

REINFORCEMENT OF SUPERVISORY POWERS

- We consider that full use should be made of the enforcement of existing MIFID provisions […] before consideration is given to the use of a power to ban practices or operations.
- Regarding position limits, we support the view taken by the FSA and HM Treasury […] that they have not seen evidence to indicate that a blanket approach through specific position limits is the most effective way to monitor, detect and deter manipulative behaviour in derivative markets, whether they are on-exchange or OTC.

2. DEVELOPMENTS IN MARKET STRUCTURES

(1) What is your opinion on the suggested definition of admission to trading? Please explain the reasons for your views.

We welcome the commitment to review MiFID in light of changing market practices and technological developments to ensure that all types of trading venues are appropriately regulated. Our view on the proposed expansion of the definition of 'admission to trading' would ultimately depend on the precise definition of organised trading facility and the criteria associated with this category of venue.

(2) What is your opinion on the introduction of, and suggested requirements for, a broad category of organised trading facility to apply to all organised trading functionalities outside the current range of trading venues recognised by MiFID? Please explain the reasons for your views.

We strongly support the existing flexibility and choice provided by MiFID. The introduction of a new trading venue in the form of OTFs should not compromise this choice. The OTF regime must therefore:

- be clearly defined to give market participants certainty about what it covers; and
- provide a suitable degree of flexibility to ensure that the value that derives from the existing diversity of execution models is not lost.

It is also important to maintain appropriate and differentiated regulatory requirements across RMs, MTFs and OTFs – given that each will have different characteristics and serve different needs

(3) What is your opinion on the proposed definition of an organised trading facility? What should be included and excluded?

Please see our answer to questions 9 and 10 for our comments on the OTF regime.

The question of what should be included and excluded in the regime will ultimately depend on the requirements associated with it. The greater the flexibility associated with the regime, the greater its potential coverage.

A broad regime would be welcome in order to be able to respond to existing and developing market needs. It should also respect the existing operation of the broker market for OTC derivatives; in this context we would particularly emphasise the distinction between the US broker market, where electronic systems dominate, and the EU market, where voice trading dominates.

Furthermore, the definition should also be drafted in such a way so as not to capture systems that merely channel trading flow (an individual bank might operate in excess of 100 such systems, and their inclusion would not provide any benefit to regulators). Likewise, intragroup systems should not be caught.

The definition of OTC trading should also be tightened to ensure that its coverage is clear.

(4) What is your opinion about creating a separate investment service for operating an organised trading facility? Do you consider that such an operator could passport the facility?

In principle, we do not oppose the concept of creating a separate investment service for operating an OTF and support the proposal that the operator of an OTF should be conferred the right to passport the facility. However, we note that reliance on existing licences and simple registration would achieve the same regulatory objectives at considerably less administrative cost.

(5) What is your opinion about converting all alternative organised trading facilities to MTFs after reaching a specific threshold? How should this threshold be compared with the global volume of trading per asset class/financial calculated, e.g. assessing the volume of trading per facility/venue instrument? Should the activity outside regulated markets and MTFs be capped globally? Please explain the reasons for your views.

We are against the idea of converting organised trading facilities to MTFs after reaching a specific threshold. There are many different models for negotiating and executing a derivatives transaction and market participants – whether hedgers, dealers or investors – should retain a choice between different models to reflect their needs. Any conversion as envisaged in this question would hinder the ability of market participants to select the most appropriate trading venue, with negative consequences for market risk, volatility and competition. In short, size should not be the distinguishing factor between MTFs and OTFs.

(6) What is your opinion on the introduction of, and suggested requirements for, a new sub-regime for crossing networks? Please explain the reasons for your views.

We understand the rationale for introducing a sub-regime for broker crossing networks, however further clarity is needed in respect of the associated requirements, especially those relating to transparency.

(7) What is your opinion on the suggested clarification that if a crossing system is executing its own proprietary share orders against client orders in the system then it would prima facie be treated as being a systematic internaliser and that if more than one firm is able to enter orders into a system it would be prima facie be treated as a MTF? Please explain the reasons for your views.

We disagree with the presumption that if a BCN is executing proprietary share orders against client orders in the system it would prima facie be treated as a Systematic Internaliser. We believe there should be a distinction between market making by a firm deliberately within a system (which we accept be treated as under the SI rules) and other unrelated proprietary orders, such as hedging activity. It is also the case that only in relation to liquid share trading would the SI regime apply.

(8) What is your opinion of the introduction of a requirement that all clearing eligible and sufficiently liquid derivatives should trade exclusively on regulated markets, MTFs, or organised trading facilities satisfying the conditions above? Please explain the reasons for your views.

ISDA supports allowing participants to determine whether or not to trade on an organized trading platform (whether Regulated Market, MTF or OTF). While increased use of trading platforms will bring benefit for particular derivative product types that are suitable for such venues, we believe that mandatory or incentivized use of such platforms where such products are not suitable to their use will (a) not reduce risk and (b) will negatively affect market participants and markets in general.

As the G20 recognised, it is not always appropriate for derivatives trading to take place on organised trading platforms even if transactions have been become relatively standardised in some respects (e.g. in legal or operational terms). There are many differing models for negotiating and executing a derivatives transaction and market participants should retain a choice between these different models to reflect their particular needs. Please see our response to Q.12 for comments on the risks involved in concentrating the market into particular venues.

Eligibility for clearing

The standardization of contracts for clearing is a different process to that for trading on exchanges and platforms and these two distinct approaches should not be confused – a contract might exhibit the necessary standardization for clearing, but nonetheless be unsuitable for trading on a particular venue, whether Regulated Market, MTF or OTF.

The interest rate derivatives market is an example of a customised market that continues to expand its clearing eligible set of products in the context of standard legal documentation and customizable contract terms. The interest rate derivatives market has been cleared for over ten years with SwapClear currently having over 1.49 million contracts cleared, many of which are distinct, economically different trades. Similarly, a significant proportion of OTC Commodity Derivatives are already settled via central counterparties – monthly metrics provided by major dealers put the figure at over 35% of trades (over 45% for Energy).

We therefore believe that the assessment of whether a derivative is suitable for trading on a particular trading venue should be made separately to the assessment of its eligibility for central clearing. However, to the extent that a product's clearing status is used in such an assessment, then a contract that is clearing eligible, but not in fact cleared (due to an exemption under EMIR, for example), should not be subject to a requirement to trade on such a venue.

Sufficient liquidity

It is essential to bear in mind that derivatives trade far less frequently than securities, such that many products will not be suitable for trading on a particular venue. As such, a liquidity criterion would be difficult to administer in practice.

Take the example of interest rate swaps. There are less than 2,000 standardized interest rates swaps executed on an average day. The largest maturity – 10 year dollar swaps – trade about 200 times a day or once every four minutes assuming a 12 hour global trading day. Most standardized swaps trade 20 times or less per day or once every half hour. In all, there might be 600 US dollar trades a day and 400 Euro trades a day. Lower frequency of trading does not, however, imply market inefficiency, as demonstrated by the extremely narrow spreads that exist in the interest rate swap market.[2]

Similarly, DTCC data for the CDS market shows that in the six month period of 21 December 2009 to 20 June 2010 only 5 names averaged 20 trades per day. They were all sovereign entities. It should also be noted that a single reference name may have multiples of 40 distinct contracts available for trading and there can be great differences in liquidity depending on the remaining maturity. As the trades age, they will become less liquid. In addition, changes in volatility can have an impact on liquidity. Some may say that this is like futures where there is a wide array of contracts available for

[2] See www.isda.org/media/pdf/ISDATestReport.pdf

trading and little activity in the vast majority. However, unlike illiquid futures contracts which cater to the small investor, the average CDS trade is about $5 million for single names and it is geared to large investors.

(9) Are the above conditions for an organised trading facility appropriate? Please explain the reasons for your views.

Non-discriminatory multilateral access

Each OTF should be permitted to establish its own admission requirements within certain guidelines. In particular, requiring non-discriminatory multilateral access would significantly limit the variety of execution models potentially captured within the OTF regime.

Support for application of pre- and post-trade transparency

We would note that there is already a good degree of pre-trade price transparency across the continuum of asset classes; the joint AFME/BBA/ISDA response to CESR on non-equities market transparency summarised the various avenues available.[3] These include various electronic platforms as well broker screens, data vendors and price aggregators. Market participants are principally institutional and professional in nature and are able to access pre-trade transparency through multiple venues and formats.

The degree of public transparency that exists in a given market will often reflect the needs of both the buy- and sell-side participants in that market. Indeed, transparency is not necessarily one of the most significant factors in determining the preference of market participants in terms of venue selection, as illustrated by a survey of bond market participants conducted by ICMA.[4]

Similarly, the degree of transparency that exists might also reflect the fundamental characteristics of the market, such that further transparency would not be possible, given the risk that liquidity could be impacted or anonymity compromised.[5] For example, some single-name CDS might trade only very occasionally and even very liquid derivative markets tend to be dwarfed by the associated cash market.[6]

The level of transparency required of an OTF should therefore be set at a realistic level that does not impair the functioning of the market. We would note in particular the inherent drawbacks associated with a pre-trade transparency regime given the infrequency of trading in many derivative contracts (for more on this point please see the response to question 10) and the fact that a derivatives contract will not have a price associated with it until the various terms have been agreed by the counterparties to the deal.

There may, of course, be a need for regulators to have access to transaction data beyond what is publicly available, for example to be able to monitor systemic risk. To avoid harming the functioning of the market, regulators might opt to instigate *private* transparency rules to complement public sources of transparency (see comment below on transaction reporting).

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[3] AFME/ISDA/BBA Joint response to CESR on non-equities market transparency in the context of the MIFID review, June 2010, pp. 4-12, http://www.cesr-eu.org/popup_responses.php?id=5668

[4] See http://www.icmagroup.org/ICMAGroup/files/1f/1fa026d7-c864-4f55-8f5c-13d1231ed87b.pdf

[5] Eunice Bet-Mansour, 'On Price Transparency of OTC Derivatives', Actualize Consulting, New York, March 2010, online at http://www.actualizeconsulting.com/OTCPriceTransparency_Actualize%20Consulting.pdf

[6] See http://www.isda.org/media/press/2010/press031510.html

Reporting of transaction data to trade repositories

We support the reporting of usable transaction data to trade repositories and are ready to work with the European Commission and ESMA to ensure that the format and content of reports is appropriate for the needs of regulators.

Designated systems or facilities in place for execution of trades

The definition should also be drafted in such a way so as not to capture systems that merely channel trading flow - an individual bank might operate in excess of 100 such systems, and their inclusion would not provide any benefit to regulators.

(10) Which criteria could determine whether a derivative is sufficiently liquid to be required to be traded on such systems? Please explain the reasons for your views.

We believe that there are significant risks associated with requiring particular contracts to be traded on a particular venue (see our responses to Q.12 for more on this).

However, if a liquidity threshold is to be used as part of the assessment of whether a product should be traded on an OTF, then that threshold should be:

- set at a realistic level that differentiates between products;
- capable of being calculated and predicted;
- subject to periodic review; and
- able to accommodate temporary changes in the market.

Supervisors should not, however, underestimate the difficulties associated with assessing whether the threshold has been met and the fact that trading frequency in over-the-counter markets is low relative to that of exchange-traded securities.

Take the example of interest rate swaps. There are less than 2,000 standardized interest rates swaps executed on an average day. The largest maturity – 10 year dollar swaps – trade about 200 times a day or once every four minutes assuming a 12 hour global trading day. Most standardized swaps trade 20 times or less per day or once every half hour on average. In all, there might be 600 US dollar trades a day and 400 Euro trades a day. Lower frequency of trading does not, however, imply market inefficiency, as demonstrated by the extremely narrow spreads that exist in the interest rate swap market.[7]

Similarly, DTCC data for the CDS market shows that in the six month period of 21 December 2009 to 20 June 2010 only 5 names averaged 20 trades per day. They were all sovereign entities. It should also be noted that a single reference name may have multiples of 40 distinct contracts available for trading and there can be great differences in liquidity depending on the remaining maturity. As the trades age, they will become less liquid. In addition, changes in volatility can have an impact on liquidity. Some may say that this is like futures where there is a wide array of contracts available for trading and little activity in the vast majority. However, unlike illiquid futures contracts which cater to the small investor, the average CDS trade is about $5 million for single names and it is geared to large investors.

[7] See www.isda.org/media/pdf/ISDATestReport.pdf

(11) Which market features could additionally be taken into account in order to achieve benefits in terms of better transparency, competition, market oversight, and price formation? Please be specific whether this could consider for instance, a high rate of concentration of dealers in a specific financial instruments, a clear need from buy-side institutions for further transparency, or on demonstrable obstacles to effective oversight in a derivative trading OTC, etc.

We believe that promoting a particular type of platform is not the only way to achieve the benefits set out in this question. Indeed, many, of those benefits can be attained through electronic confirmation, clearing and the use of trade repositories.

In light of this, we welcome the publication of the European Commission's proposal for a Regulation on OTC derivatives, central counterparties and trade repositories. The Regulation introduces a reporting obligation for OTC derivatives, a clearing obligation for eligible OTC derivatives, measures to reduce counterparty credit risk and operational risk for bilaterally cleared OTC derivatives, common rules for central counterparties (CCPs) and for trade repositories, and rules on the establishment of interoperability between CCPs.[8]

Where appropriately designed, such measures can help manage risk in the OTC derivatives market. As outlined in our response[9] to the Commission's proposal, there are a number of important issues that need to be borne in mind:

- Central counterparties should be used where they reduce risk in the financial system.
- Although many contracts will be suitable for clearing, some will not (on a prudent basis) and some may cease to be eligible.
- Bilateral risk management provides an important alternative to central clearing, where central clearing will not reduce counterparty and systemic risk or is otherwise inappropriate.
- Regulatory reporting via trade repositories is valuable as a systemic risk tool.
- Some participants in derivatives business should benefit from an exemption from clearing requirements, when considering the risk associated with these activities and the negative (overall) risk and liquidity impacts a requirement to clear/collateralise derivative positions could imply.

(12) Are there existing OTC derivatives that could be required to be traded on regulated markets, MTFs or organised trading facilities? If yes, please justify. Are there some OTC derivatives for which mandatory trading on a regulated market, MTF, or organised trading facility would be seriously damaging to investors or market participants? Please explain the reasons for your views.

The risks associated with the requirement to trade on a particular venue (whether regulated market, MTF, or organised trading facility) will depend on the criteria associated with that venue. For example, an effective OTF regime will need to be able to accommodate a diverse range of execution models, without compromising the flexibility that currently exists.

A brief survey of the markets for different product classes is illustrative of that diversity:

- In the credit derivatives area, executable market platforms exists for a small population of liquid index products (e.g. dealer pages on Bloomberg). Though these are available, they are not commonly used by end-users, but in the inter-dealer market electronic execution

[8] See http://ec.europa.eu/internal_market/financial-markets/derivatives/index_en.htm
[9] See http://www.isda.org/speeches/pdf/isdaafmensaassosimcommentsreEMIR1011043.pdf

platforms see significant use. Request-For-Quotations facilities exist in platforms like Market Axess or Creditex where clients can get prices and execute electronically.

- In equity derivatives, exchanges have a long history of attracting liquidity from the OTC markets as contracts become more liquid and commoditised, and as they are naturally incentivised to do so (see B-Clear, FLEX Options and block-crossing mechanisms). Additional services are continuously added as client side demand dictates. Wholesale broker aggregation services also exist (BrokerHub, CScreen, Vectalis), with varying degrees of use.

- In interest rate derivatives, TradeWeb and Bloomberg are two of the major electronic platforms for multi-dealer execution for clients and provide access to tight bid/offer spreads, while single dealer platforms also allow for price discovery and trade execution.

- The FX market was an early pioneer of modern flexible electronic trading (Reuters Matching; ICAP EBS). In particular for FX spot (where there are a limited number of parameters), multiple competing electronic platforms exist that provide clients with a wide choice of execution methods including streaming prices ("click and deal"), request for quote (RFQ), single or blended liquidity, algorithmic trading, etc.

- The commodities market itself is diverse (such that each sector needs to be considered separately) – OTC trading can range from broker screens, to voice broking to bilateral trades for the most bespoke trades. Further, entities such as Platts and Argus provide price transparency services for certain products.

If the OTF regime is inflexible in its design and/or promoted too aggressively for products currently traded OTC, then the following risks could materialize:

- **The inability to customize:** Overly-ambitious promotion of a particular execution model would likely concentrate trading activity in a subset of existing contracts, weakening the ability of market participants to customize contracts. More importantly, concentrating the market into a more narrow range of products linked to particular venues could potentially increase systemic risk, as clients would not have the ability to hedge and appropriately manage their unique risks.

- **Loss of the means to manage risk:** The public transparency criteria associated with organized venues could prove problematic for market participants, particularly hedging counterparties, who could find the market more likely to move against them when they trade. For example, for some commodity contracts, where the number of participants is very low, disclosing the transaction, even on an anonymous basis, would be sufficient to identify the participants in the transaction and would not result in useful market information due to the specificity of the price. Furthermore, the interaction with EMIR could lead to a requirement to collateralise positions that would work to the disadvantage – or even exclusion – of corporate end users.

- **Loss of market efficiency:** The unit size of OTC trades are typically larger than those on-exchange, reflecting (a) the professional nature of the market (exchanges often have a significant retail level of participation – at least for some types of instrument) and (b) the customized nature of the product (it is easier for counterparties to agree one deal, than for a counterparty to have to purchase many units of a smaller-denominated exchange-traded contract). Transparency requirements can result in decreases in order/transaction size and

increased trade frequency. These can be signs of an inefficient market, as they can be the result of the unwillingness of market participants to perform effective risk transfer functions. For example, on the CME algorithmic traders contribute a large part of daily volume but for the most part this liquidity is intra-day, which does not ensure overnight risk transfer in the same way as dealers in the OTC markets. Markets characterized by those features can also be more vulnerable to risks of the kind illustrated by the recent 'flash crash' in the US and the removal of human interaction can in fact make systems more vulnerable.

Indeed, the existence of an organized market for a given product does not necessarily imply greater efficiency relative to an over-the-counter market in tailored products. A significant proportion of futures contracts – which are typically highly standardized and readily tradable – fail to attract and sustain a profitable level of trading volume and ultimately fail.[10] A study by CFTC economist Michael Penick found that of the 632 futures contracts listed since 1940, 72% had survived 1 year, 44% had survived 2 years, and only 10% had survived 10 years.[11]

A further reason for maintaining alternative methods of negotiating or executing trades is to allow for the possibility of significant drops in liquidity (such as where there is a jump in volatility). In those circumstances, market participants will wish to be able to seek out and negotiate with the available sources of liquidity on a bilateral basis. Constraints on their ability to do so will exacerbate market disruptions by restricting alternative sources of liquidity. For example, during the financial crisis there was a significant drop in volumes in standardized, plain vanilla exchange traded contracts.

Annex 1 provides case studies that illustrate why moving business onto particular venues might not be beneficial or, indeed, possible in the case of certain instruments.

(13) Is the definition of automated and high frequency trading provided above appropriate?

(14) What is your opinion of the suggestion that all high frequency traders over a specified minimum quantitative threshold would be required to be authorised?

It is our understanding that these measures are not targeted towards OTC derivatives transactions.

(15) What is your opinion of the suggestions to require specific risk controls to be put in place by firms engaged in automated trading or by firms who allow their systems to be used by other traders?

We believe that the controls already mandated under European legislation are adequate.

(16) What is your opinion of the suggestion for risk controls (such as circuit breakers) to be put in place by trading venues?

We support the establishment of such controls, as long as these are appropriately calibrated, monitored and reviewed in close consultation co-operation with trading venue participants

[10] B. Wade Brorsen and N'Zue F. Fofana, 'Success and Failure of Agricultural Futures Contracts', in *Journal of Agribusiness* 19,2, online at http://www.jab.uga.edu/Library/f01-03.pdf

[11] Cited in Robert W. Kolb and James A. Overdahl, *Understanding futures markets* (Wiley-Blackwell, 2006)

(17) What is your opinion about co-location facilities needing to be offered on a non-discriminatory basis?

We support non-discriminatory access to co-location facilities.

(18) Is it necessary that minimum tick sizes are prescribed? Please explain why.

We support the prescription of minimum tick sizes to avoid a 'race to the bottom' in tick sizes.

(19) What is your opinion of the suggestion that high frequency traders might be required to provide liquidity on an ongoing basis where they actively trade in a financial instrument under similar conditions as apply to market makers? Under what conditions should this be required?

While HFT may offer liquidity for significant fractions of the trading day, ongoing market making requirements do not appear appropriate.

(20) What is your opinion about requiring orders to rest on the order book for a minimum period of time? How should the minimum period be prescribed? What is your opinion of the alternative, namely of introducing requirements to limit the ratio of orders to transactions executed by any given participant? What would be the impact on market efficiency of such a requirement?

We are very concerned that a requirement for orders to rest on the order book for a minimum period of time will create a disincentive to the provision of liquidity. The alternative proposal to introduce order:transaction ratios seems unworkable. Instead, we suggest the incorporation of gradually increasing financial cost to act as a disincentive to quote-stuffing

(21) What is your opinion about clarifying the criteria for determining when a firm is a SI? If you are in favour of quantitative thresholds, how could these be articulated? Please explain the reasons for your views.

(22) What is your opinion about requiring SIs to publish two sided quotes and about establishing a minimum quote size? Please explain the reasons for your views.

We have no specific comments to make on these questions.

(23) What is your opinion of the suggestions to further align organisational requirements for regulated markets and MTFs? Please explain the reasons for your views.

Where the nature and scale of competing business models are similar then they should be similarly regulated. However, we are against the idea of MTFs being forced to adopt the 'regulated market' business model. The two models are efficient because of their specificities and their differences; investors should still be free to choose between two different businesses. Alignment of requirements must not impair clients' freedom of choice in a way that would ultimately be detrimental to competition, innovation, and investors' and issuers interests.

(24) What is your opinion of the suggestion to require regulated markets, MTFs and organised trading facilities trading the same financial instruments to cooperate in an immediate manner on market surveillance, including informing one another on trade disruptions, suspensions and conduct involving market abuse?

We support measures that would encourage trading venues to work together on market surveillance.

(25) What is your opinion of the suggestion to introduce a new definition of SME market and a tailored regime for SME markets under the framework of regulated markets and MTFs? What would be the potential benefits of creating such a regime?

Broadly, the suggestion of a special regime for SMEs within the RM/MTF regime, with tailored provisions on management and oversight of the market and pre- and post-trade transparency seems sensible.

A good example of a successful special regime is AIM. The London-based stock exchange provides SMEs the ability to raise capital on a market with a tailored regime suitable to the characteristics of smaller and younger companies. The benefits of a customized regime are that smaller firms can possibly fund their development and growth objectives at a lower cost of capital than would be the case if the criteria for raising capital were modified. Without a bespoke regime SMEs may struggle to access the markets.

(26) Do you consider that the criteria suggested for differentiating the SME markets (i.e. thresholds, market capitalisation) are adequate and sufficient?

We have no specific comments to make on this question.

3. PRE- AND POST-TRADE TRANSPARENCY

(27) What is your opinion of the suggested changes to the framework directive to ensure that waivers are applied more consistently?

We welcome the commitment to enhance the waiver application process and would urge the European Commission to develop a process that is inclusive of all stakeholders and sufficiently flexible to take account of developments in market practice and technology.

(28) What is your opinion about providing that actionable indications of interest would be treated as orders and required to be pre-trade transparent? Please explain the reasons for your views.

We agree that an 'actionable' or 'executable' indication of interest should be treated as an order.

(29) What is your opinion about the treatment of order stubs? Should they not benefit from the large in scale waiver? Please explain the reasons for your views.

We see no reason why order stubs should not become pre-trade transparent. The priority for our members is to ensure that the original large order maintains the use of pre-trade transparency waivers.

(30) What is your opinion about prohibiting embedding of fees in prices in the price reference waiver? What is your opinion about subjecting the use of the waiver to a minimum order size? If so, please explain why and how the size should be calculated.

We agree that the embedding of fees in prices in the price reference waiver should be prohibited. However, we are concerned about the potential extension of the underlying principle and its impact on the broker/dealer fee-model. We do not support the application of a minimum order size on the basis of its detrimental impact on competition and thus user/investor choice: the broker/dealer must have discretion in respect of the sizing of the order to avoid market impact.

(31) What is your opinion about keeping the large in scale waiver thresholds in their current format? Please explain the reasons for your views.

The large-in-scale waiver is rarely used, suggesting that it is set too high. We propose that the threshold should be regularly reviewed and amended if supported by evidence.

(32) What is your opinion about the suggestions for reducing delays in the publication of trade data? Please explain the reasons for your views.

We note that the Commission does not justify the reduction of permitted delays. According to our analysis of MarkitBOAT data, only 0.1% of trades representing 4.4% of value traded use deferred publication after the day of trade, so there is little to be gained in restricting the right to delayed publication. Transparency would be improved more by a focus on eliminating late reporting of trades (which affects 5.9% of trades and 8.1% of value in our analysis). We recommend that task of reviewing the entire deferred reporting regime (not just 'numbers' but underlying principles) be delegated to ESMA together with the obligation to consult fully with all stakeholders.

(33) What is your opinion about extending transparency requirements to depositary receipts, exchange traded funds and certificates issued by companies? Are there any further products (e.g. UCITS) which could be considered? Please explain the reasons for your views.

(34) Can the transparency requirements be articulated along the same system of thresholds used for equities? If not, how could specific thresholds be defined? Can you provide criteria for the definition of these thresholds for each of the categories of instruments mentioned above?

(35) What is your opinion about reinforcing and harmonising the trade transparency requirements for shares traded only on MTFs or organised trading facilities? Please explain the reasons for your views.

We have no specific comments to make on these questions.

(36) What is your opinion about introducing a calibrated approach for SME markets? What should be the specific conditions attached to SME markets?

We would welcome further detail as to what such a calibrated approach might entail.

(37) What is your opinion on the suggested modification to the MiFID framework directive in terms of scope of instruments and content of overarching transparency requirements? Please explain the reasons for your views.

We note that the proposed scope of the Commission's transparency regime would be extremely broad, and as such would not prove sufficiently sensitive to different asset classes or the fact that particular segments of the market trade much more frequently than others – note the statistics provided in our response to Q.8.

As for pre-trade transparency, the ISDA/AFME/BBA Joint Response to CESR in the context of its Technical Advice to the Commission set out the extensive range of price data that is available to market participants by asset class. We do not support the introduction of a prescriptive pre-trade transparency regime; this could well undermine the functioning of these markets, given that there would be a disincentive for liquidity providers to publish prices, particularly on more illiquid products.

As for post-trade transparency, we support the development of a formal regulatory regime, as long as it is sensitive to the nature of the market, with time delays and size-related thresholds.

(38) What is your opinion about the precise pre-trade information that regulated markets, MTFs and organised trading facilities as per section 2.2.3 above would have to publish on non-equity instruments traded on their system? Please be specific in terms of asset-class and nature of the trading system (e.g. order or quote driven).

Pre-trade transparency has evolved in line with market demand (bearing in mind that there is no truly retail participation in OTC derivatives). The exact mechanism may vary by asset class, reflecting different characteristics of the products and participants. End-users have a better overview of market pricing than dealers, who are not in a position to see their competitors' price quotes.

We do not see a strong rationale to mandate a particular form of pre-trade transparency given the current situation.

More detailed commentary is provided for individual asset classes under Annex 2. Please also see the ISDA/AFME/BBA Joint Response to CESR in the context of its Technical Advice to the Commission on non-equity transparency which has been appended to our response.

(39) What is your opinion about applying requirements to investment firms executing trades OTC to ensure that their quotes are accessible to a large number of investors, reflect a price which is not too far from market value for comparable or identical instrument traded on organised venues, and are binding below a certain transaction size? Please indicate what transaction size would be appropriate for the various asset classes.

In the case of tailored OTC derivatives, the requirement to quote to the general public would be highly problematic and ultimately harmful to end users (e.g. insurance companies/pension funds) that are legitimately attempting to manage their risks, which can be quite complex. To begin with it is unclear what is meant by "to quote" as for the more structured products, banks do not provide a two way quote but offer a price for a "solution". Such solutions can take weeks if not months to finalise and can be very large in size. Moreover, the products themselves can be quite illiquid, even those considered more vanilla (eg rates options). Disclosure of the transaction to the market could harm clients since the market would immediately be able to ascertain the client position and move against it, while at the same time likely breaching client confidentiality.

Moreover, the requirement for the "quote" to reflect a price not too far from market value for "comparable or identical instruments" traded on organised venues does not address the counterparty credit risk as you could have two identical products but the price would differ depending on the perceived creditworthiness of the counterparty. There is also a question around what is meant by "comparable", particularly in respect of highly bespoke products, where by definition there is no benchmark price[12]. Moreover, a price will always reflect the situation at the time it is made and therefore will not necessarily be comparable.

(40) In view of calibrating the exact post-trade transparency obligations for each asset class and type, what is your opinion of the suggested parameters, namely that the regime be transaction-based, and predicated on a set of thresholds by transaction size? Please explain the reasons for your views.

We support the introduction of a post-trade transparency regime for OTC derivatives based on transactions and governed by thresholds:

- Post-trade transparency should apply to confirmed trades only. This would avoid the risk of delivering misleading information to the market.

- More generally, we believe that transparency requirements should be calibrated to the liquidity of the market in question.

In particular, the latter point would be supported through the establishment of appropriate exemptions for block trades. In defining block trade exemption rules, it would be important to, consider the following[13]:

[12] See http://www.isda.org/speeches/pdf/MIFIDCESRtrans040405.pdf

[13] See attached ISDA/SIFMA paper 'Block trade reporting for over-the-counter derivatives markets'

- **Minimum trade size thresholds** – By definition, block trade exemptions require clear definitions of the criteria that qualify transactions as block trades subject to special reporting requirements. This threshold or "minimum block size" is commonly a function of the average trade size or the cumulative distribution of trades for a specific instrument. Market regulators frequently target a percentage of transactions that will qualify as block trades, but also take into consideration a wide range of market factors (e.g. average daily trade volume).

- **Reporting delays** – Reporting delays of appropriate length allow market participants to hedge the market risk of block trades during the delay period. The delay mechanism is most effective when instruments or contracts are very liquid and either fungible or highly standardized,8 and minimum block sizes are set at reasonable levels. If these requirements are met, participants are able to hedge entirely the market risk of block trades during the reporting delay.

- **Limited disclosure** – Many products do not have sufficient liquidity to ensure that risks from a block trade can be sufficiently hedged during a relatively short reporting delay period. In many cases, markets permit participants in block trades to report limited information regarding block trades. The most common form is a volume dissemination cap – the market is informed that a transaction above the cap has occurred, but not the exact size of the transaction. Markets may also grant volume dissemination caps for more liquid products in cases where the block trade is a multiple of the block minimum. The limited disclosure mechanism ensures that price discovery remains intact for block trades while protecting post-block trade hedging needs from being anticipated by other market participants.

More detailed commentary is provided for individual asset classes under Annex 3. Please also see the ISDA/AFME/BBA Joint Response to CESR in the context of its Technical Advice to the Commission on non-equity transparency which has been appended to our response.

(41) What is your opinion about factoring in another measure besides transaction size to account for liquidity? What is your opinion about whether a specific additional factor (e.g. issuance size, frequency of trading) could be considered for determining when the regime or a threshold applies? Please justify.

Please refer to our response to Q.40

(42) Could further identification and flagging of OTC trades be useful? Please explain the reasons.

While it may be useful for post-trade reporting venues and trade repositories to store information on the originating system for a trade, we do not believe that an OTC flag would provide useful information.

4. DATA CONSOLIDATION

(43) What is your opinion of the suggestions regarding reporting to be through approved publication arrangements (APAs)? Please explain the reasons for your views.

(44) What is your opinion of the criteria identified for an APA to be approved by competent authorities? Please explain the reasons for your views.

(45) What is your opinion of the suggestions for improving the quality and format of post trade reports? Please explain the reasons for your views.

In general terms, we support the establishment of the proposed Approved Publication Arrangement (APA), but would emphasise the importance of avoiding double reporting and counting of trades.

(46) What is your opinion about applying these suggestions to non-equity markets? Please explain the reasons for your views.

Please refer to our response to Q.59.

(47) What is your opinion of the suggestions for reducing the cost of trade data? Please explain the reasons for your views.

While possibly helpful in development of a post-trade consolidated tape, unbundling of pre- and post-trade data is unlikely to lead to a reduction in costs. Given that market participants need to access to *all* data, primary exchanges will retain pricing power. Indeed, evidence suggests that venues have actually increased prices post-unbundling.

(48) In your view, how far data would need to be disaggregated? Please explain the reasons for your views.

Data would ideally be disaggregated by sectors, markets and key index constituents – all with a view to giving market participants flexibility in their data purchasing decision. We stress the need for consistency between Leve1 and Level 2 provisions in this respect.

(49) In your view, what would constitute a "reasonable" cost for the selling or dissemination of data? Please provide the rationale/criteria for such a cost.

Market data is a public good/utility and should ideally be provided at cost. However, we recognize the need for a cost structure that incentivizes continual improvements in the service delivered and so would accept cost plus a reasonable return.

(50) What is your opinion about applying any of these suggestions to non-equity markets? Please explain the reasons for your views.

Please refer to our response to Q.59.

(51) What is your opinion of the suggestion for the introduction of a European Consolidated Tape for post-trade transparency? Please explain the reasons for your views, including the advantages and disadvantages you see in introducing a consolidated tape.

(52) If a post-trade consolidated tape was to be introduced which option (A, B or C) do you consider most appropriate regarding how a consolidated tape should be operated and who should operate it? Please explain the reasons for your view

(53) If you prefer option A please outline which entity you believe would be best placed to operate the consolidated tape (e.g. public authority, new entity or an industry body).

(54) On Options A and B, what would be the conditions to make sure that such an entity would be commercially viable? In order to make operating a European consolidated tape commercially viable and thus attaining the regulatory goal of improving quality and supply of post-trade data, should market participants be obliged to acquire data from the European single entity as it is the case with the US regime?

(55) On Option B, which of the two sub-options discussed for revenue distribution for the data appears more appropriate and would ensure that the single entity described would be commercially viable?

(56) Are there any additional factors that need to be taken into account in deciding who should operate the consolidated tape (e.g. latency, expertise, independence, experience, competition)?

(57) Which timeframe do you envisage as appropriate for establishing a consolidated tape under each of the three options described?

(58) Do you have any views on a consolidated tape for pre-trade transparency data?

We have no specific comments to make on these questions.

(59) What is your opinion about the introduction of a consolidated tape for non-equity trades? Please explain the reasons for your views.

We believe that it will be appropriate to introduce a consolidated tape for non-equity trades at some stage, but, bearing in mind the primary focus on key markets with sufficient volume and liquidity, the Commission should take a pragmatic and tailored approach to requiring the introduction of a consolidated tape for non-equity trades, prioritising those that are particularly important. Clearly, the less liquid and the more tailored the non-equity product, the less value (and more cost) there will be in a consolidated tape. This is particularly so in the case of OTC derivatives markets.

5. MEASURES SPECIFIC TO COMMODITY DERIVATIVE MARKETS

(60) What is your opinion about requiring organised trading venues which admit commodity derivatives to trading to make available to regulators (in detail) and the public (in aggregate) harmonised position information by type of regulated entity? Please explain the reasons for your views.

ISDA supports the adoption of a harmonised approach towards position information and the importance of regulators obtaining a comprehensive and objective picture of the activities of different types of traders. ISDA recognises that such a picture will be helpful, but believes that the regulatory "targets" behind this obligation should be set out in more detail.

ISDA notes the intention to make position information on an aggregated basis available to the public, so that the public may be able to assess "the activities of different market participants". ISDA does not see the purpose behind making this information public, even in an aggregated form, insofar as its value to the public is not entirely clear, but, on the other hand, exposing the dealings of market participants, particularly if groups are very narrowly defined, would be deeply damaging commercially to them.

(61) What is your opinion about the categorisation of traders by type of regulated entity? Could the different categories of traders be defined in another way (e.g. by trading activity based on the definition of hedge accounting under international accounting standards, other)? Please explain the reasons for your views.

The three options suggested all rely on the ability of firms to report on a transaction basis on the categorisation status of customers and/or whether a transaction is a hedge under IFRS IAS 39. All three suggestions are problematic as firms' deal capture systems do not contain this information and developing such capture systems is likely to be challenging, especially for firms which currently are not required to report transactions to regulators. Using MiFID categories to report is problematic, as the same entity may have a different categorisation at different firms for legitimate reasons. In addition, the "hedge" classification is difficult as firms do not identify whether a trade is a hedge or not and clients may be reluctant to provide this information as it could be commercially sensitive. In addition, hedging activities such as those surrounding energy portfolios, tend to be dynamic with a large number of variables (such as weather, customer behaviour, interest rates, and supply and demand fundamentals) therefore, hedging tends to be equally dynamic as a result taking place at portfolio a rather than a transaction level making the proposal difficult to comply with.

An alternative approach would be to introduce a categorisation system based on the functions performed by different participants, e.g. producers, consumers/transformers, dealers, liquidity providers.

(62) What is your opinion about extending the disclosure of harmonised position information by type of regulated entity to all OTC commodity derivatives? Please explain the reasons for your views.

We do not have any objections to position reporting per se. However, OTC transactions are mostly bespoke in their nature and so would provide little relevant information to markets about price formation; indeed, disclosure obligations could in fact carry the significant risk of giving the market a misleading representation of activities, whilst also compromising commercially sensitive information. We note that OTC contract information will be available to regulators via trade

repositories and that most regulated market rules allow for the request of relevant data if they suspect that their market is being affected by potentially abusive behaviour taking place in the OTC market.

Furthermore, we would urge the Commission to ensure that whatever reporting and transparency arrangements are proposed, that these are harmonised with other initiatives such as EMIR and the MAD review, as well as the DG Energy REMIT proposals, and should be designed in such a way that transactions are reported only once to a single database (i.e. a trade repository) from which regulators can draw the information to support their objectives.

(63) What is your opinion about requiring organised commodity derivative trading venues to design contracts in a way that ensures convergence between futures and spot prices? What is your opinion about other possible requirements for such venues, including introducing limits to how much prices can vary in given timeframe? Please explain the reasons for your views.

We believe that regulatory mandates and incentivisation in the area of contract design would be inappropriate and could seriously distort markets to the point where they fail to meet commercial needs. Contract design is essentially a matter for exchanges and market participants. ISDA does not believe that the emergence of certain problems in some US agricultural derivatives is sufficient justification to change the current basis of developing an appropriate contract design. Such a problem has not emerged and is unlikely to emerge in the EU. It should also be noted that exchanges have no incentive to produce contracts that distort the relationship between futures and spot prices.

At present, market infrastructure operators will liaise with their competent authority on the introduction of new contracts and, so far as ISDA is aware, this has always worked well and efficiently. By way of contrast, ISDA would point out that US exchanges were required to submit any new contracts to the US Commodity Futures Trading Commission (CFTC) to determine their economic viability, but this practice was abandoned insofar as it was found to impair innovation and reduce the competitiveness of the US markets.

While ISDA understands concerns over excessive price volatility and high commodity prices, the key issue is market integrity, i.e. that a market is orderly and properly supervised and that trading is authentic and free of manipulation. The introduction of artificial controls designed to limit/control the price formation process will result in distorted pricing and progressive loss of market integrity; with the result that trading will migrate to alternative venues. It is also important to bear in mind that exchanges already have a wide range of powers that can be exercised in extremis.

(64) What is your opinion on the three suggested modifications to the exemptions? Please explain the reasons for your views.

We appreciate the arguments in favour of amending the exemptions, but are of the view that any practical attempt at such should not be made unless and until the consequences of bringing additional firms within scope of MiFID are more fully understood; in particular, this will require consideration of the associated prudential regime.

We also support the suggestion of the FOA that further work be undertaken on this issue by a cross-sectoral industry working group to explore the diverse views of industry participants.

(65) What is your opinion about removing the criterion of whether the contract is cleared by a CCP or subject to margining from the definition of other derivative financial instrument in the framework directive and implementing regulation? Please explain the reasons for your views.

ISDA believes it is important to review the MiFID product definitions to ensure that they continue to be up-to-date, but they should continue to exclude not just spot, but also physical forward contracts (as was originally intended by the definitions in MiFID), as these are and remain commercial arrangements.

In this context, ISDA would caution that:

a) some exchanges and other venues do offer trading facilities in physical spot and forward contracts that are not derivatives;

b) forward physical contracts are often standardised in terms of their contractual arrangements for purposes of commercial efficiency; and

c) physical forward contracts may be priced in relation to already published prices or may even, coincidentally, replicate standardised delivery points; this is the case where a derivative market has developed as an adjunct to the underlying physical market, e.g. north sea crude; and

d) physical forward contracts are used by a significant number of market participants engaged in trade and commerce (e.g. generation of electricity, and gas sales).

yet the parties will still usually intend to make/take physical delivery in order to meet their supply and delivery obligations, i.e. the contract will still essentially be a “commercial purpose” contract.

(66) What is your opinion on whether to classify emission allowances as financial instruments? Please explain the reasons for your views.

ISDA believes that the current approach of excluding emission allowances (“EUA”) as financial instruments under MiFID, but capturing derivative contracts based on such allowances, is the appropriate way forward because:

a) EUAs are not in themselves financial instruments;

b) as is pointed out in the CP, the role and purposes of the “physical” EUA markets are different from those of financial markets;

c) the financial capture of a large number of non-financial companies would be inappropriate, bearing in mind that they do not carry on “investment business” and, in the context of EUAs, do not have retail customers;

d) the quantum of systemic risk is extremely low; and

e) extending the scope of financial regulation to include non-financial underlying products/instruments could create a precedent in relation to other non-financial assets and will generate “turf” issues with physical regulators.

While ISDA does not believe it is appropriate for dealings in emission allowances to be subject to financial regulation, this is a market which does call for closer regulation, but by the physical regulatory authorities.

6. TRANSACTION REPORTING

Please also refer to ISDA Response to CESR on Consultation on guidance to report transactions on OTC derivative instruments.[14]

As a general comment, we would stress the need to align regulatory initiatives that impact on the way firms report to authorities, trade repositories and the market, to ensure that those initiatives are non-duplicative. The linkages between MiFID and EMIR are particularly important in this regard.

(67) What is your opinion on the extension of the transaction reporting regime to transactions in all financial instruments that are admitted to trading or traded on the above platforms and systems? Please explain the reasons for your views.

We believe that transaction reports provide a useful mechanism for monitoring securities and securities derivatives markets[15]. For commodities, foreign exchange and interest rate derivatives, the risk of abuse relates to market manipulation and we therefore believe that position reports collected by exchanges are the appropriate tool for supervisory oversight, as opposed to transaction reports. This follows the line taken by CESR in its Technical Advice on this issue.

We note that extending transaction reporting obligations to non-securities derivatives[16] would place a significant additional burden on investment firms – and indeed competent authorities – and could well be technically frustrated by the lack of internationally accepted instrument identifiers for non-securities derivatives.

As noted above, we support the Commission's proposed requirements for transaction reporting of securities and securities derivatives traded solely on EEA trading venues, including Multilateral Trading Facilities (MTFs) and Organised Trading Facilities (OTF). We would suggest that the obligation apply to those instruments 'solely traded on MTFs/OTFs', given that most instruments issued outside the EU will trade on at least one European MTF or OTF and would otherwise be caught. This will ensure that European competent authorities aren't put in the position of having to monitor all financial instruments issued globally.

(68) What is your opinion on the extension of the transaction reporting regime to transactions in all financial instruments the value of which correlates with the value of financial instruments that are admitted to trading or traded on the above platforms and systems? Please explain the reasons for your views.

We believe that the definition of 'correlates' in this context could well prove too broad. As an alternative, we would suggest the wording "…the value of which is derived from, or which is otherwise dependent on the value of financial instruments that are admitted to trading…" to focus on the direct link between the two instruments.

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[14] See http://www.cesr-eu.org/popup_responses.php?id=5320

[15] In particular equity and credit derivatives

[16] Under the present rules reporting on non-securities derivatives (including commodities derivatives) transactions are made to the local regulators by the operators of the relevant regulated markets.

(69) What is your opinion on the extension of the transaction reporting regime to transactions in depositary receipts that are related to financial instruments that are admitted to trading or traded on the above platforms and systems? Please explain the reasons for your views.

We have no specific comments to make on this question.

(70) What is your opinion on the extension of the transaction reporting regime to transactions in all commodity derivatives? Please explain the reasons for your views.

We are of the view that position reporting is a more efficient method of monitoring for potential market abuse in the commodity derivatives markets; indeed, this is the approach taken by the US Commodity Futures Trading Commission (CFTC), which relies on position reports for maintaining integrity in the commodity derivatives markets in the United States.

For traded securities, transaction reporting is important for uncovering potential abuses such as insider dealing, misusing information and giving false or misleading impressions when allied to scrutiny of company disclosures. However, the same cannot be said of transaction reports with respect to commodity derivatives, particularly where settlement of contracts is by physical delivery of the underlying commodity and the major forms of market abuse are corners or squeezes. Given the nature of potential abuse in commodity derivatives, position information is of far greater value to regulators.

Please also refer to our response to Q.62.

(71) Do you consider that the extension of transaction reporting to all correlated instruments and to all commodity derivatives captures all relevant OTC trading? Please explain the reasons for your views.

Please refer to our response to Q.67.

(72) What is your opinion of an obligation for regulated markets, MTFs and other alternative trading venues to report the transactions of non-authorised members or participants under MiFID? Please explain the reasons for your views.

We welcome moves to collect transaction reports in all applicable instruments from non-authorised members in order to enhance the ability of Competent Authorities to detect and deter market abuse. However, we would note that most of these trading venues are not currently able to collect the required information from non-authorised firms in order to adequately transaction report to all Competent Authorities. Making the required changes will increase the costs incurred by the trading venues, which will - in all likelihood - be passed onto the investment firms and investors.

(73) What is your opinion on the introduction of an obligation to store order data? Please explain the reasons for your views.

We not see a strong case for introducing such an obligation. Currently, regulators may request information of this nature, which generally exists and is of an adequate standard. The trading venues themselves also monitor for market abuse using software that has been specifically designed look for suspicious order patterns (as well as trades), such as orders attempting to 'layer the book' and patterns of order/cancellations (spoofing). These processes work well.

OTC orders are not typically recorded in a system as this is unnecessary. Rather, they are recorded on bespoke documents called term-sheets which are very similar to legal documents. A regulator might request details of OTC orders as evidence of abusive activity; which they may well do if a transaction was cancelled before execution and they were suspicious that this was as a result of receipt of inside information.

(74) What is your opinion on requiring greater harmonisation of the storage of order data? Please explain the reasons for your views.

It is already standard practice for trading venues (and firms) to store orders. Generally, this is done via extensive automated systems. They are capable of recording information (including order information) that is critical to firm's businesses and regulatory responsibilities. The decisions on how this data is stored will depend to a large extent on the specific nature and size of the business in question. Harmonising the way orders are held would require firms to re-build an enormous amount of front end client facing and trading systems, which would come at a significant expense to firms, without delivering any obvious benefits.

(75) What is your opinion on the suggested specification of what constitutes a transaction for reporting purposes? Please explain the reasons for your views.

We are unsure of the benefit of the proposal, given that the current definition found within Article 5 of the Commission's implementing regulation works well and is understood.

(76) How do you consider that the use of client identifiers may best be further harmonised? Please explain the reasons for your views.

We fully support the proposal, in principle, that all should be identified with a meaningful identifier in a transaction report. It appears that this is a pre-requisite for authorities to monitor the markets efficiently and effectively.

(77) What is your opinion on the introduction of an obligation to transmit required details of orders when not subject to a reporting obligation? Please explain the reasons for your views.

CESR addressed the issue of client ID collection when orders are transmitted for execution in its technical advice to the Commission in context of the MiFID review. CESR's proposal was to amend MiFID to require that Member States ensure that, when orders are transmitted for execution, the transmitting firm either:

- transmits the client ID to the receiving firm; or
- reports the trade to the Competent Authority with a mark that differentiates it from ordinary executions, including the full client ID, to the Competent Authority

The Commission's proposal goes beyond CESR's advice, in that it would remove the option for the receive and transmitting firm to report the client ID directly to the relevant Competent Authority itself.

Our members wholeheartedly agree that it is important to try to identify the originator of the trade through transaction reports. However, we don't think this is necessarily best achieved by forcing the receiver and transmitter of an order (RTO firm) to transmit the identity of the client to the executing broker. Indeed, this approach presents a number of issues:

1. It may be the case that the underling client does not wish for their details to be passed to the executing firm. It is most unlikely an underlying client would give their consent to the RTO firm to pass their details on to an executing firm with which they have no direct relationship;

2. An executing firm may receive several orders for the same security from a number of different RTO firms. It may then fill these orders with one single (aggregated) execution;

3. The executing firm contractually may not recognise the underlying investor as its client; thus forcing the RTO firm to either not fill the client order with the chosen executing broker or fail to provide complete transaction reporting information;

4. The proposal will also likely result in high levels of double reporting, leaving RTO firms in an unclear position with regards to in which capacity they should report; and

5. Executing firms will be forced to build multiple new systems at a significant cost in order to identify whether there is a reporting obligation or not, and if so, what that reporting obligation is (some RTO firms may report, and some may not - i.e. those where the underlying client is based outside of the EEA);

It is our firm belief that RTO investment firms should be given the choice of either transmitting the identity of the client to the executing broker or making a transaction report to the competent authority identifying the originator of the order (as per CESR's advice).

This system is currently employed by competent authorities in many European jurisdictions and works well. It represents an appropriate balance between the flexibility of RTO firms, and the detection of market abuse. To our mind, the Commission's proposal offers no more than CESR's in terms of market abuse detection. It does, however, significantly reduce the flexibility of RTO firms in meeting their transaction reporting requirements.

(78) What is your opinion on the introduction of a separate trader ID? Please explain the reasons for your views

We do not support the Commission's proposal to introduce a requirement to identify the individual trader within a firm who executes the transaction: the vast majority of our members' transactions are made on behalf of their clients and we are unsure what value the trader ID will offer the authorities when the "trader" is often not the person who made the initial decision to trade. Indeed, it seems immaterial who the individual trader is.

(79) What is your opinion on introducing implementing acts on a common European transaction reporting format and content? Please explain the reasons for your views.

In principle, we would support the harmonisation of transaction reporting format and content across the EEA. Given the significant costs involved in changing reporting formats, we believe it would be preferable to encourage harmonisation through ongoing dialogue between ESMA and the industry rather than through implementing acts. Regulators should also be consulted with, as if – in the process of harmonisation – a simpler format is chosen it is likely that some competent authorities will opt for super-equivalent implementation.

(80) What is your opinion on the possibility of transaction reporting directly to a reporting mechanism at EU level? Please explain the reasons for your views.

Theoretically speaking, from our members' perspective there would be little difference in whether firms reported to their local competent authority or directly to a central EU database. However, it seems logical that transaction reports are sent to the local competent authority, as it will be best placed to detect and investigate any potential market abuse.

A single EU reporting mechanism could potentially overcome some of the problems in determining which CAs firms should send a particular report (home/host), but not if firms had to supply information to enable the central database to allocate permissions to CAs to view transactions reports relating to branches in their jurisdiction.

We do not believe that this proposal would result in any cost savings at the CA level as the CAs have already sunk significant development costs in their report collection and surveillance systems.

(81) What is your opinion on clarifying that third parties reporting on behalf of investment firms need to be approved by the supervisor as an Approved Reporting Mechanism? Please explain the reasons for your views.

We do not support the Commission's proposal that third parties reporting on behalf of investment firms need to be approved by the supervisor as an Approved Reporting Mechanism (ARM). Many of our member firms report on behalf of their (smaller) clients, whereby the transaction reports are then sent to the chosen ARM of the investment firm. This is a bilateral agreement between the firm and its client. There is also a significant reputational risk to the reporting firm which ensures they pay proper attention to making sure the reporting is correct.

(82) What is your opinion on waiving the MiFID reporting obligation on an investment firm which has already reported an OTC contract to a trade repository or competent authority under EMIR? Please explain the reasons for your views.

Our members welcome the consultation paper's recognition of the links between transaction reporting, and the ongoing work in relation to the European Markets Infrastructure Regulation (EMIR) and Trade Repositories. We strongly support this proposal as we see obvious synergies between the two forms of reporting. However, firms will only be able take advantage of this opportunity if the data content standards for the two forms of reporting are consistent, so we would encourage the Commission to align work on these issues as far as possible.

(83) What is your opinion on requiring trade repositories under EMIR to be approved as an ARM under MiFID? Please explain the reasons for your views.

To take advantage of the reporting synergies, the trade repositories will have to become a reporting channel for transaction reporting purposes. Reporting mechanisms can adversely impact the quality and availability of transaction reports to the authorities, so we would strongly support the requirement that Trade Repositories should meet the obligations to be approved as an Approved Reporting Mechanism. If the data standards between the two forms of reporting are not compatible, this question becomes irrelevant.

7. INVESTOR PROTECTION AND PROVISION OF INVESTMENT SERVICES

(84) What is your opinion about limiting the optional exemptions under Article 3 of MiFID? What is your opinion about obliging Member States to apply to the exempted entities requirements analogous to the MiFID conduct of business rules for the provision of investment advice and fit and proper criteria? Please explain the reasons for your views.

We have no specific comments to make on this question.

(85) What is your opinion on extending MiFID to cover the sale of structured deposits by credit institutions? Do you consider that other categories of products could be covered? Please explain the reasons for your views.

We refer the Commission to the response of the Joint Associations Committee (ISDA, ICMA, AFME) to the PRIPs consultation.

(86) What is your opinion about applying MiFID rules to credit institutions and investment firms when, in the issuance phase, they sell financial instruments they issue, even when advice is not provided? What is your opinion on whether, to this end, the definition of the service of execution of orders would include direct sales of financial instruments by banks and investment firms? Please explain the reasons for your views.

An offer of financial instruments is not, of itself, an investment 'service' activity and so rightly falls to be regulated not by MiFID, but by other regulation such as the Prospectus, Transparency and Market Abuse Directives. This should be the case regardless of whether the issuer is a state, a pharmaceutical company, a bank or some other kind of entity.

That said, a non-gratuitous offer of financial instrument necessarily involves the sale of such financial instruments and in turn the reception and transmission of orders or their execution. Whilst this may be obvious where distinct entities are involved in addition to investors (namely the issuer and independent intermediaries), these concepts equally apply where only one entity (the issuer) is dealing with the investors as the single entity can be considered to be performing distinct economic functions. In this respect, any outward facing activities should be subject to MiFID no differently than if such activities were conducted by an independent entity.

(87) What is your opinion of the suggested modifications of certain categories of instruments (notably shares, money market instruments, bonds and securitised debt), in the context of so-called "execution only" services? Please explain the reasons for your views.

(88) What is your opinion about the exclusion of the provision of execution-only services when the ancillary service of granting credits or loans to the client (Annex I, section B (2) of MiFID) is also provided? Please explain the reasons for your views.

The Commission's Option A is broadly in line with CESR's advice, in explicitly restricting the range of shares, bonds, securitised debt, and money market instruments in relation to which firms may provide execution only services, and in proposing to abolish execution only services in conjunction with the granting of credit or loans.

The Commission's proposals for modifications in categories 7.2.1(a), (b), and (c) are reasonable in the context of requirements to assess the appropriateness of the product for retail clients. We therefore have no objection to them, provided that there is no significant modification to MIFID's

client categorisation. As explained in our answers to Questions 104-106, the Commission is suggesting the possibility of changes to client categorisation which would significantly amend clients' current classification, and which could have the effect of forcing many more expert and professional clients, currently classified as Eligible Counterparties or Professional Clients, into the retail category. To the extent that experts were forced into the retail client category, further restriction of the classes of financial instrument for which execution only services could be provided would limit investors' choice of services and increase the cost of services provided to them. Such a limitation of firms' ability to serve professional clients' needs reinforces the importance of not imposing new limitations on professional client or Eligible Counterparty status

(89) Do you consider that all or some UCITS could be excluded from the list of non-complex financial instruments? In the case of a partial exclusion of certain UCITS, what criteria could be adopted to identify more complex UCITS within the overall population of UCITS? Please explain the reasons for your views.

We refer the Commission to the response of the Joint Associations Committee (ISDA, ICMA, AFME) to the PRIPs consultation.

(90) Do you consider that, in the light of the intrinsic complexity of investment services, the "execution-only" regime should be abolished? Please explain the reasons for your views.

No. Execution-only services are a useful and efficient method of trading, demanded by retail (as well as professional) clients who are confident in trading in the market, or who need to trade, for a range of reasons (for example, in order to liquidate an investment) over which they have no control.

(91) What is your opinion of the suggestion that intermediaries providing investment advice should: 1) inform the client, prior to the provision of the service, about the basis on which advice is provided; 2) in the case of advice based on a fair analysis of the market, consider a sufficiently large number of financial instruments from different providers? Please explain the reasons for your views.

(92) What is your opinion about obliging intermediaries to provide advice to specify in writing to the client the underlying reasons for the advice provided, including the explanation on how the advice meets the client's profile? Please explain the reasons for your views.

(93) What is your opinion about obliging intermediaries to inform the clients about any relevant modifications in the situation of the financial instruments pertaining to them? Please explain the reasons for your views.

(94) What is your opinion about introducing an obligation for intermediaries providing advice to keep the situation of clients and financial instruments under review in order to confirm the continued suitability of the investments? Do you consider this obligation be limited to longer term investments? Do you consider this could be applied to all situations where advice has been provided or could the intermediary maintain the possibility not to offer this additional service? Please explain the reasons for your views.

The Commission's proposals go beyond CESR's advice, which stated that it considered that 'current requirements were comprehensive, yet sufficiently flexible, to apply to different types of clients, instruments and advised services and therefore did not need modifying'. Furthermore, in assessing CESR's advice, it is important to bear in mind that IOSCO is currently undertaking a review of

suitability, and it would make sense for revisions to MIFID to have regard to the outcome of that review.

The Commission is proposing detailed requirements on informing clients whether investment advice is independent and fair (in which case a review of the market would be required, and inducements prohibited). We recognise that customers need to be well informed on the nature of services that they receive and that the diverse financial advice landscape presents a challenge in this regard.

However, it is important for the Commission to make clear that these more detailed proposals are not intended to apply to professional clients, for the following reasons:

a) For professionals, MiFID's high level suitability obligation is appropriate. The range of services provided, and the commercial and legal remedies that are available to clients, are such that one size does not fit all, and firms and competent authorities need to be able to calibrate and enforce suitability obligations appropriately.

b) Professional investors are able to conduct their own due diligence, based on the information which firms are required by MIFID to provide, and need to be allowed to make their own judgements of the commercial risk of transactions. It is important to bear in mind that other EU regulatory developments, such as CRD 2, are encouraging investor due diligence. It is important that the MIFID revision does not work against this trend.

c) To make a judgement of suitability, and provide advice, to professional clients in relation to any more than the specific transaction in relation to which advice is requested, firms would need to obtain more information than professional clients are typically willing to provide. Suitability obligations in relation to transaction-based advice to professional clients need to be adapted to the range of circumstances in which clients may seek advice, and not impose unrealistic and unenforceable obligations. Suitability for one-off transactions can only be effectively gauged in the context of the client's particular needs for the transaction concerned at the time when the advice is provided.

Unless suitability obligations are adapted to the investment objectives and circumstances of professional clients, such clients, particularly those located outside the EU, would be more likely to seek investment services in markets outside the EU. As regards professional clients in the EU, it is better that they are subject to oversight under proportionate EU regulation than that they seek investment services in possibly less well regulated markets elsewhere.

(95) What is your opinion about obliging intermediaries to provide clients, prior to the transaction, with a risk/gain and valuation profile of the instrument in different market conditions? Please explain the reasons for your views.

(96) What is your opinion about obliging intermediaries also to provide clients with independent quarterly valuations of such complex products? In that case, what criteria should be adopted to ensure the independence and the integrity of the valuations?

(97) What is your opinion about obliging intermediaries also to provide clients with quarterly reporting on the evolution of the underlying assets of structured finance products? Please explain the reasons for your views.

(98) What is your opinion about introducing an obligation to inform clients about any material modification in the situation of the financial instruments held by firms on their behalf? Please explain the reasons for your views

(99) What is your opinion about applying the information and reporting requirements concerning complex products and material modifications in the situation of financial instruments also to the relationship with eligible counterparties? Please explain the reasons for your views.

The Commission's proposal goes beyond CESR's advice, which recommended 'strengthening investors' right to request information for professional and retail clients who trade OTC derivatives and other complex or tailor-made products, although on an appropriately calibrated basis'.

We strongly support CESR's proposals for strengthening the right of investors to request information. It is vital to ensure that investors are able to obtain the information that they require to evaluate an investment and to gauge whether to retain it. As CESR advised, this need is better met on the basis of demand by the client.

An alternative approach would be to make it possible for clients to request a valuation at particular intervals during the life of the product – minimizing the risk of overloading the client with unnecessary/unwanted information that could lead to switching when this is not in the client's longer-term interest.

The following disadvantages to clients would arise from a blanket obligation:

a) Requiring all clients to receive so much information, even though they may not require it, would impose on them additional cost. Clients, particularly professional clients, need to be able to retain control over the amount of information that they need and with what frequency, as a commercial matter in accordance with their own identified needs. CESR identified the particular importance of gauging the cost of independent valuations: it is important that such valuations could be undertaken by appropriately independent persons within a firm, in order to avoid the cost of third party valuations. Furthermore, it would make sense to focus on ensuring the integrity of valuations rather than their independence, given that a valuation can be fair without necessarily having been independently produced. This issue could be dealt with through conflicts of interest provisions already established through MiFID. To mandate independent valuation would simply increase costs for clients as third-party valuation agents would likely demand a fee for the valuation service.

b) Too much emphasis on price information, particularly as regards retail clients, could discourage them from focusing on non-price considerations which are also important to investment decisions. It is particularly important not inadvertently to encourage investors to reinvest too rapidly as a result of an over-emphasis on price in declining markets, and of the fact that hedging instruments are intended to decline in value in rising markets.

These disadvantages would be exacerbated to the extent that professional clients and Eligible Counterparties were forced into the retail or professional client categories: a further reason why it is important not to make extensive changes to client classification.

Unless information requirements are adapted to the objectives and circumstances of professional clients, such clients, particularly those located outside the EU, would be more likely to seek investment services in markets outside the EU.

(100) What is your opinion of, in the case of products adopting ethical or socially oriented investment criteria, obliging investment firms to inform clients thereof?

Investment firms will already provide clients with a fund's investment strategy through their fund fact sheet which will outline the investment criteria. If clients have invested on the basis of ethical or socially orientated investment principles and the products cease to have these characteristics, then we believe firms should inform their clients of this change. Clients should have the opportunity to request additional information however sending information to clients who do not request it may lead to important documents being dismissed as another unwanted update.

(101) What is your opinion of the removal of the possibility to provide a summary disclosure concerning inducements? Please explain the reasons for your views.

(102) Do you consider that additional ex-post disclosure of inducements could be required when ex-ante disclosure has been limited to information methods of calculating inducements? Please explain the reasons for your views.

(103) What is your opinion about banning inducements in the case of portfolio management and in the case of advice provided on an independent basis due to the specific nature of these services? Alternatively, what is your opinion about banning them in the case of all investment services? Please explain the reasons for your views.

Some of the problems of interpretation of the MiFID Inducement rule have arisen from the fact that it has been interpreted by European CAs as a broad payments rule. Currently there is ambiguity as to how far these rules apply and whether they cover areas such as Commission sharing agreements and intra-group tax sales credits. This leads to inconsistent applications of the directive across Europe. We consider it would help to clarify the application of the rule to consider whether a revision is in order, whereby inducements are limited to those payments specifically intended to induce firms to act in a way that calls into doubt their obligation to act solely in the best interests of their client.

In principle we agree that the use of summary disclosure concerning inducements should be removed as an option for firms. Nevertheless, we think it is important that clients should continue to be able to request more detailed disclosure of inducements including additional ex post disclosure of inducements when ex ante disclosure has been limited to information methods of calculating inducements. Amendment of the Directive should therefore be limited to the deletion of the word 'summary'.

In the case of portfolio management, we believe that providers should not be prohibited from making payments to intermediaries where this is simply facilitating payments for advice which have been agreed between the customer and the advice intermediary and to which the product provider has had no influence in setting this amount.

(104) What is your opinion about retaining the current client classification regime in its general approach involving three categories of clients (eligible counterparties, professional and retail clients)? Please explain the reasons for your views.

We strongly agree that the current classification between eligible counterparties, professional, and retail clients should be retained. The reasons for doing so are fully explained in CESR's October 2010 technical advice and the response we made to CESR's consultation, attached to our response by way

of background. CESR concluded, agreeing with respondents, that 'the categories of clients, and the obligations attaching to each, are generally appropriate and do not need changing – certainly not on a major scale'.

In general, we believe that the current tiered approach to customer categorisation provides appropriate levels of investor protection to the three categories. Our experience has shown that transactions executed since the implementation of the regime have not resulted in significant numbers of client complaints and that the regime provides a proportionate and graduated system of investor protection that is relatively recent, has been implemented at significant cost and is maturing well. The ability of clients to opt for greater regulatory protection at any time is an important safety feature already built into the process and should not be overlooked in suggesting any changes to the regime.

Despite the Commission's comment in section 7.2.5, we do not think that the detailed proposals would leave the regime largely unchanged. The Commission's proposed blurring of the boundaries of the categories, and imposition of new requirements on eligible counterparties and professional clients, would introduce uncertainty and obstruct intermediaries' ability to fulfil clients' investment needs in ways which are not justified by the stated reasons.

In particular, it is important to be clear that 'alleged mis-selling practices' are not a reason to change client classifications: they should be dealt with by proper compliance with, and enforcement of, mis-selling rules, or, in the case of eligible counterparties, the proposed new provision on acting honestly, fairly, and not misleadingly. As CESR confirmed, the 'current crisis' has not revealed any fundamental flaws in the existing client classification.

(105) What are your suggestions for modification in the following areas:

a) Introduce, for eligible counterparties, the high level principle to act honestly, fairly and professionally and the obligation to be fair, clear and not misleading when informing the client;

We would support changing the existing standards such that they included obligations for eligible counterparties to act honestly, fairly and professionally; and to communicate in a way that is fair, clear and not misleading as we see these as pre requisite for any lasting commercial relationship or properly functioning market.

b) Introduce some limitations in the eligible counterparties regime. Limitations may refer to entities covered (such as non-financial undertakings and/or certain financial institutions) or financial instruments traded (such as asset backed securities and nonstandard OTC derivatives);

These proposals would go well beyond CESR's advice which concluded that the existing regime works well and proposed only limited modifications. We agree with CESR's advice because it appropriately recognises that the efficiency of international capital markets depends on the ability of counterparties to deal with each other willingly on a basis of equality, without owing each other conduct of business obligations.

We do not believe that client categorisation rules need to be changed in relation to product types. A false link is sometimes made between product complexity and product risk, which leads to the illusion that complex instruments are automatically high-risk instruments. In fact in OTC derivative markets product complexity is often the result of products being structured to create more tailored and, quite possibly, less risky investment outcomes. For example, contrast the case where a client

pays 3-month Euribor® with one where the client pays 3-month Euribor® capped at 5% and floored at 1%. The first case involves a much simpler product and payment structure but has a higher exposure to outright interest rates than the second example which effectively limits exposure to parameters chosen by the client.

Further, if a client has a complex liability profile, a complex hedge will be a necessary requirement to match risk profiles. Any vanilla or less structured solution could leave the client with exposure to significant net risk which would require a high level of risk management expertise to monitor and manage.

In short, the suitability of a particular product for a particular investor is a function of the investor's knowledge and experience, financial situation and investment objectives. The complexity or otherwise of a product is just one factor in the making this determination – what matters is whether the investor understands what the risks are and what the returns are likely to be.

The CP does not explain why the Commission suggests radical limitation of access to ECP status, which would limit the competitiveness of the EU relative to third countries, and therefore make EU markets less attractive to international investors and issuers. Any concerns about inequality of bargaining power are adequately dealt with by the ability of ECPs to request a change of client status. The introduction of an obligation to deal with eligible counterparties fairly, honestly, and not misleadingly will address any market conduct issues that arise. Forcing counterparties to act towards each other as professional clients would raise a number of problems, including:

a) It would not be apparent which party owed conduct of business obligations to the other, nor, if there was a conflict of obligations, which obligation would prevail;

b) typically, counterparties want to deal with each other in the market on the basis of information which would not be complete enough to fulfil client conduct of business obligations

c) in competitive international wholesale markets, counterparties need to be able to deal with each other quickly and efficiently, without the procedural constraint of detailed conduct of business obligations.

Furthermore, it is important to take into account the reinforced basis for fair counterparty interaction which has been introduced by recent EU legislation, including the CRD revisions, Solvency 2, and AIFMD.

Analysis of the impact of Commission proposals on EU markets, their users and the EU economy

Although the short consultation period has made it difficult to undertake a thorough assessment of the proposals, we have asked our Member firms to estimate the impact that the proposals would be likely to have on the conduct of investment services and activities on behalf of investors and issuers. We consider that the Commission's proposals, insofar as they go beyond what CESR advised, would severely harm EU markets, their users (investors and issuers), and the economic interests of the EU. Restricting the basis on which entities are able to choose how they interact with the market would make EU markets unattractive for issuers and investors both within the EU and from the rest of the world. EU markets, and the EU economy, would suffer, while issuers, investors, intermediaries, in primary and secondary markets, could migrate to third countries whose regimes better accommodate their investment and capital-raising needs, for example in Asia.

The imposition of retail-client-oriented conduct of business standards on relationships with professionals might encourage vexatious accusations of misconduct if the market moves against a client's position, and thereby diminish firms' willingness to provide services to them. More importantly, by focusing scarce supervisory attention on dealings with professionals, less supervisory attention would necessarily be given to the protection of retail clients, who would therefore be harmed, not protected, by DG Markt's proposals.

As in the case of Eligible Counterparties, the nature of firms' dealings on behalf of professional clients is often such that firms would not be in a position to carry out extensive due diligence to ascertain the knowledge and experience of another professional: such clients typically guard proprietary or confidential information about their status, positions, and objectives. Often professional clients are willing to reveal only the information that is necessary to enable the firm to understand the particular transaction in relation to which investment services are sought. Furthermore, it is intrinsically harder to assess the knowledge and experience of a collective body than of an individual. It is also the case that professional clients' priority is often to deal quickly: removal of the assumption of knowledge and experience, and imposition of related conduct of business obligations in these circumstances, would slow business down and impede firms' ability to serve professional clients' needs.

These impacts would be compounded by the interaction with any respects in which the Commission's other proposals in the CP, which envisage more stringent conduct of business rules for both professional and retail clients, would apply to professional clients.

Alternative proposal As in all aspects of the review of MIFID, we consider that the driving objectives should be to promote in the EU markets that serve in the most efficient and safe way (a) investors' need to obtain an optimal real return on their investments, and (b) issuers' need to obtain an optimal cost of capital. We consider that these objectives are best served by taking action to address specific issues that have given rise to problems, but leaving the existing Eligible Counterparty regime, which works well, unchanged. Such specific actions include:

a) the Commission's proposals to introduce a fair, honest, and not misleading obligation for dealings between Eligible Counterparties;

b) effective application and enforcement, by the Commission through Lamfalussy Level 4 if necessary, of provisions on Eligible Counterparties' ability to choose professional client status;

c) appropriate provision of information on financial instruments to Eligible Counterparties.

In this way the Commission will be able to remedy the defects that experience of MIFID has revealed, while also ensuring that EU markets remain strong and internationally competitive, providing the best combination of safeness, effective regulation, choice, competition, and efficiency to investors and issuers not only within the EU, but also worldwide.

c) Clarify the list of eligible counterparties and professional clients per se in order to exclude local public authorities/municipalities? Please explain the reasons for your views.

We believe that local authorities and municipalities should be specifically excluded from the definitions of entities in Annex II.1 (3) and from the size criteria of Annex II. 1 (2) and therefore could

only be treated as professional if they meet the criteria and follow the process set out in Annex II part II.

We believe a further enhancement to clarity and consistency of treatment of "local authorities" would be achieved by the Commission publishing summaries of the abilities of "local authorities" to engage in financial market activity under national laws and rules governing their constitution.

A local authority, as a professional client, can always request that it be opted down to be treated as a non professional client: the protection that would result from changing the categorization of a party can already be achieved by the party itself without changing the existing framework.

(106) Do you consider that the current presumption covering the professional clients' knowledge and experience, for the purpose of the appropriateness and suitability test, could be retained? Please explain the reasons for your views.

For the reasons set out in CESR's advice and our response to CESR's consultation, the current presumption of professional clients' knowledge and experience should be retained for all purposes.

The Commission's proposal to eliminate or limit to less complex financial instruments the assumption that professional clients have the necessary level of competence, so that they would be subject to a more rigorous assessment of suitability or appropriateness, goes well beyond CESR's advice. CESR concluded that the existing regime works well, proposed only limited modifications, and specifically stated that client categorisation need not be changed in relation to OTC derivatives or complex products.

We refer the Commission again to our response to CESR's consultation. We agree with CESR's advice because it appropriately recognises that professional clients are better able to judge their own needs, or to request advice, or purchase it externally, than are retail clients.

We believe that those entities currently included in Annex II.I are all highly likely to be actively engaged in the capital markets and are by their very nature among the most au fait with the current MiFID rules, including those which permit such entities to request treatment as "non professional". We believe that it would be unnecessary to incorporate requirements for investment firms to assess the knowledge and experience of these entities where in the overwhelming majority of cases the result would be the same as if no such assessment been required. The cost and effort to carry out and maintain records of such assessments would therefore far outweigh the possible benefits of doing so. Further, in those limited circumstances where an entity which is classified as a "per se professional" does not actively engage in the capital markets and begins to do so, our experience suggests it will almost always involve professional advisers, including law firms, which will be able to advise on the existence of the "opt down" provisions. The cost of administering a set of knowledge and experience assessments for the very small subset of per se professionals that could potentially be impacted seems a disproportionate and an unnecessary burden given our experience with such entities.

In summary, we believe that all professional clients under Annex II are fully capable, able and, most importantly, actually do, ask for a higher level of protection where they feel they are unable to properly assess or manage the risks involved.

We consider that the Commission's further proposals, insofar as they go beyond what CESR advised, would severely harm EU markets, the interests of both professional and retail clients, and the

economic interests of the EU. Restricting the basis on which professional entities are able to choose how they interact with the market would make EU markets unattractive for issuers and investors both within the EU and from the rest of the world. EU markets, and the EU economy, would suffer, while clients and intermediaries could migrate to third countries, for example in Asia, which better serve their needs.

The imposition of retail-client-oriented conduct of business standards on relationships with professionals might encourage vexatious accusations of misconduct if the market moves against a client's position, and thereby diminish firms' willingness to provide services to them. More importantly, by focusing scarce supervisory attention on dealings with professionals, less supervisory attention would necessarily be given to the protection of retail clients, who would therefore be harmed, not protected, by the Commission's proposals.

As in all aspects of the review of MIFID, we consider that the driving objectives should be to promote in the EU markets that serve in the most efficient and safe way (a) investors' need to obtain an optimal real return on their investments, and (b) issuers' need to obtain an optimal cost of capital. We consider that these objectives are best served by focusing on specific targeted actions to address the issues that have given rise to problems, but leaving the existing client classification, which works well, unchanged. Such specific actions include:

a) effective application and enforcement of provisions on professional clients' ability to choose retail client status;

b) appropriate provision of information on financial instruments to professional clients;

c) effective enforcement of mis-selling and other relevant rules.

In this way the Commission will be able to remedy the defects that experience of MIFID has revealed, while also ensuring that EU markets will thus remain strong and internationally competitive, providing the best combination of safeness, effective regulation, choice, competition, and efficiency to investors and issuers not only within the EU, but also worldwide.

(107) What is your opinion on introducing a principle of civil liability applicable to investment firms? Please explain the reasons for your views.

(108) What is your opinion of the following list of areas to be covered: information and reporting to clients, suitability and appropriateness test, best execution, client order handling? Please explain the reasons for your views.

The consultation indicates that civil liability obligations apply to all clients, perhaps including professionals. Such obligations in relation to investment business for professional clients could give rise to moral hazard, and de-stabilise EU markets, by encouraging vexatious claims of breaches where the market moves against professional clients' positions. That is why the UK legislation, for example, restricts civil liability for rule breaches to retail clients. On this basis, we believe that it would not be appropriate to introduce a general principle of civil liability to investment firms.

(109) What is your opinion about requesting execution venues to publish data on execution quality concerning financial instruments they trade? What kind of information would be useful for firms executing client orders in order to facilitate compliance with best execution obligations? Please explain the reasons for your views

(110) What is your opinion of the requirements concerning the content of execution policies and usability of information given to clients should be strengthened? Please explain the reasons for your views.

We have no specific comments to make on these questions.

(111) What is your opinion on modifying the exemption regime in order to clarify that firms dealing on own account with clients are fully subject to MiFID requirements? Please explain the reasons for your views.

Under Article 4 of MIFID, dealing on own account with clients implies the provision of an investment service or ancillary service to those clients. We think that it is implicit in the wording and interpretation of MIFID that firms executing client orders by dealing on own account are providing an investment service. We therefore have no objection to the Commission's proposal to include the clarification suggested.

(112) What is your opinion on treating matched principal trades both as execution of client orders and as dealing on own account? Do you agree that this should not affect the treatment of such trading under the Capital Adequacy Directive? How should such trading be treated for the purposes of the systematic internaliser regime? Please explain the reasons for your views.

We agree with the Commission that it must be clear that any treatment of matched principal trades must not affect their treatment under CAD.

(113) What is your opinion on possible MiFID modifications leading to the further strengthening of the fit and proper criteria, the role of directors and the role of supervisors? Please explain the reasons for your view.

(114) What is your opinion on possible MiFID modifications leading to the reinforcing of the requirements attached to the compliance, the risk management and the internal audit function? Please explain the reasons for your view.

(115) Do you consider that organisational requirements in the implementing directive could be further detailed in order to specifically cover and address the launch of new products, operations and services? Please explain the reasons for your views.

(116) Do you consider that this would imply modifying the general organisational requirements, the duties of the compliance function, the management of risks, the role of governing body members, the reporting to senior management and possibly to supervisors?

In assessing what further measures are needed, we advocate the European Commission be mindful of measures already undertaken in some Member States. Some, including the UK, are already well advanced in their review of corporate governance and risk arrangements.

The CP does not specify what the Commission means by 'new products'. We consider that controls should apply only to mean new types of financial instruments, but not to instruments that are similar in character to existing ones

In the UK, for example, the Walker Report determined that there should be an approval process for new products, but saw it as the responsibility of the Chief Risk Officer to assess, independently of the executive, whether a proposed product launch was consistent with risk tolerance determined by the risk committee and the board. A requirement that the Board of Directors approve new products would result in the board becoming too operational in nature – at the cost of its strategic oversight role.

(117) Do you consider that specific organisational requirements could address the provision of the service of portfolio management? Please explain the reasons for your views.

We have no specific comments to make on this question.

(118) Do you consider that implementing measures are required for a more uniform application of the principles on conflicts of interest?

Existing MIFID requirements are adequate to regulate conflicts of interest arising in selling. Failures should be dealt with by enforcement.

We do not agree with the Commission's assertion that:

> *"For instance, it would be very difficult for a firm which creates strong incentives for its sales staff to sell certain products, e.g. through internal bonus structures, to be able to manage the conflicts of interest thereby created. It is unlikely that such a firm could, in this situation, demonstrate compliance with MiFID".*

Firm staff would still have to ensure through appropriateness and suitability tests that the product was right for the client otherwise they could be accused of mis-selling. We consider that this issue should be dealt with through improved enforcement of the current MiFID requirements. We do not consider implementing measures are required for a more uniform application of the principles on conflicts of interest.

(119) What is your opinion of the prohibition of title transfer collateral arrangements involving retail clients' assets? Please explain the reasons for your views.

Firms who offer title transfer collateral arrangements, via stock loan, repo or OTC derivative products, to retail clients generally do so through the Private Banking or Wealth Management divisions. Such divisions' generally only deal with retail clients who have a significant amount of assets available for investment. These retail clients also generally have a sophisticated outlook to the financial markets and they understand the risks involved as they often have many years experience of the investment market across a variety of products and services. On many occasions, these retail clients require customised products. Accordingly, we do not support a prohibition of title transfer collateral arrangements involving retail clients.

We would, however, support measures to help ensure that retail clients fully appreciate the risks involved – please see our response to Q.121.

(120) What is your opinion about Member States be granted the option to extend the prohibition above to the relationship between investment firms and their non retail clients? Please explain the reasons for your views.

We oppose this proposal on the basis that non-retail clients generally have the sophistication and experience to understand the risks involved in title transfer collateral arrangements. Non-retail clients generally have immediate access to legal advice, either from in-house lawyers or from an external law firm.

It is worth noting that the UK Financial Services Authority elected not to prohibit title transfer collateral arrangements between firms and non-retail clients when they reviewed the operation of this sector of the market in 2010.

We believe that the provision of timely and appropriate information to non-retail clients is the key. In the UK, Prime Brokers are required to supply non-retail clients with daily information on how their pledged assets and collateral is being used by the Prime Broker unit of the financial institution, together with the overall indebtedness to the Prime Broker including any cash balances. The provision of this information permits the non-retail client to actively monitor how the Prime Broker is utilising his assets and we believe adopting similar rules in the EU may meet the Commission's regulatory objectives.

(121) Do you consider that specific requirements could be introduced to protect retail clients in the case of securities financing transaction involving their financial instruments? Please explain the reasons for your views.

We would support the introduction of a requirement for financial institutions to produce clear, fair and not misleading documentation specifically targeted at retail clients explaining both the types of products in which title transfer collateral arrangements are an integral part and the risks that are inherent in such arrangements.

(122) Do you consider that information requirements concerning the use of client financial instruments could be extended to any category of clients?

We refer to our answer to Question 120 which discusses the daily provision of information to non-retail clients by Prime Brokers on how the clients pledged assets and collateral is being used together with details of the overall indebtedness of the client to the financial institution or vice versa.

It may be appropriate to extend a similar requirement for retail clients, but it will be important that financial institutions provide the information in a manner that is comprehensible to retail clients. Additionally, it may be appropriate for the financial institution to make the information available on a basis to be agreed between it and the retail client, but not less than on a monthly basis.

(123) What is your opinion about the need to specify due diligence obligations in the choice of entities for the deposit of client funds?

We support the retention of the current requirement for investment firms to conduct due diligence procedures on credit institutions with whom they may place client funds.

We feel it is important that the Commission specify the relevant percentage of client funds to be held with authorized credit institutions outside the corporate group of the financial institution as many of our members operate throughout the EU and to permit Member States to set the appropriate percentage would risk the creation of an unlevel playing field.

We also believe guidance should also be given in respect of whether it is appropriate for the credit institutions selected to be of a lower credit rating than that of the house bank. We can see it may be appropriate for the Commission to consider setting guidance on the maximum amount, or percentage of total client money, that may be placed with a related bank, but such requirements must recognise that the operating or transaction accounts for the business are likely to be with that house bank. From a risk perspective, this arrangement reduces the reliance by the group on the capabilities of third party banks. The operating or transaction accounts will process client margin calls, returns from exchanges and the movement of balances between the third party banks, based on the credit assessments or day-to-day rebalancing. The limit set for the house bank should reflect this need and any limit established should be measured at the end of the day and not be required at all times. In the event of local regulatory concerns with a particular firm, additional regulatory oversight can be applied at that point.

It would seem also relevant for the Commission to set guidance on the amounts that can be placed with third party banks, but the scale of client money to be placed will differ from firm to firm and, as a result, risk tolerances will be different. We believe that setting rules that create a level playing field will be difficult and the rules may need to be tiered. We believe that the Commission should also implement a diminimus level, beneath which diversification need not be applied. This could allow the house bank to be used for all client money where the client money identified is incidental to the business and where there is no operating or transaction account as is the case under the alternative approach in the UK. If this was not considered acceptable, one third party bank should be allowed, but with a contingency plan to change banks in emergencies. We believe this will go a long way to reducing the overheads in the process for relatively small amounts of client money.

(124) Do you consider that some aspects of the provision of underwriting and placing could be specified in the implementing legislation? Do you consider that the areas mentioned above (conflicts of interest, general organisational requirements, requirements concerning the allotment process) are the appropriate ones? Please explain the reasons for your views.

We have no specific comments to make on this question.

8. FURTHER CONVERGENCE OF THE REGULATORY FRAMEWORK AND OF SUPERVISORY PRACTICES

(125) What is your opinion of Member States retaining the option not to allow the use of tied agents?

(126) What is your opinion in relation to the prohibition for tied agents to handle clients' assets?

(127) What is your opinion of the suggested clarifications and improvements of the requirements concerning the provision of services in other Member States through tied agents?

(128) Do you consider that the tied agents regime require any major regulatory modifications? Please explain the reasons for your views.

We have no specific comments to make on these questions.

(129) Do you consider that a common regulatory framework for telephone and electronic recording, which should comply with EU data protection legal provisions, could be introduced at EU level? Please explain the reasons for your views.

(130) If it is introduced do you consider that it could cover at least the services of reception and transmission of orders, execution of orders and dealing on own account? Please explain the reasons for your views.

(131) Do you consider that the obligation could apply to all forms of telephone conversation and electronic communications? Please explain the reasons for your views.

(132) Do you consider that the relevant records could be kept at least for 3 years? Please explain the reasons for your views.

We agree that a common regulatory framework for telephone and electronic recording could be introduced. Additionally we agree with the recording requirements outlined above and that all forms of telephone conversation and electronic communications should be considered. The recording process should help provide a complete and accurate audit trail concerning how a transaction is marketed, sold and executed.

It should be clear that the specific regulatory purpose of such recording is to enable CAs to access records to support investigations of market abuse. It should be clear that no obligation arises on the firm to review recordings. Retention requirements should not impose undue cost on firms. Rather than imposing burdensome long retention periods on a blanket basis, regulators should be encouraged to complete preliminary investigations of suspected cases quickly, and have the ability to ask firms to retain specific records beyond a shorter blanket period.

We believe that six months would be a suitable and cost effective requirement. The costs of implementing a retention period of three years would outweigh the benefits realised by CAs in terms of market abuse detection and resolution of client issues.

Firms' current systems do not have capacity to support a retention period of three years. Estimates from our membership have indicated that the total set up and ongoing works required for a retention of six months (for both mobile and landline records) will cost EUR 1.3m per firm. This increases incrementally to EUR 7.5m per firm when looking at a three year retention period. We

consider that it would be appropriate for EC to expect CAs to improve their initial identification of suspect cases in order to save firms the additional cost of EUR 6m.

For landline calls only, the ongoing costs are estimated to increase incrementally from EUR 35,000 per month for 6 months' storage to EUR 150,000 per month after 3 years' storage.

For mobile phone recording, the initial set-up costs are estimated at EUR 500,000. The ongoing costs for 6 month's retention of mobile records are estimated at EUR 133,000 per month. These rise incrementally to EUR 200,000 per month after three years storage.

(133) What is your opinion on the abolition of Article 4 of the MiFID implementing directive and the introduction of an on-going obligation for Member States to communicate to the Commission any addition or modification in national provisions in the field covered by MiFID? Please explain the reasons for your views.

Article 4 of the Level 2 Directive has provided a useful control over the introduction by Member States of superequivalent national rules. Firms generally favour consistency of the rules to which they are subject across the EU. Deleting Article 4 and relying on a notification mechanism might make it easier for Member States to add restrictive national rules.

Our members would be concerned if the proposed new system of Member States communicating to the Commission any addition or modification in the text of the national provisions in the field covered by MiFID, could make it easier for national regulators to introduce additional 'superequivalent' rules which would have costly impacts on firms and lead to inconsistent application of MiFID across Europe.

(134) Do you consider that appropriate administrative measures should have at least the effect of putting an end to a breach of the provisions of the national measures implementing MiFID and/or eliminating its effect? How the deterrent effect of administrative fines and periodic penalty payments can be enhanced? Please explain the reasons for your views.

(135) What is your opinion on the deterrent effects of effective, proportionate and dissuasive criminal sanctions for the most serious infringements? Please explain the reasons for your views.

(136) What are the benefits of the possible introduction of whistleblowing programs? Please explain the reasons for your views.

(137) Do you think that the competent authorities should be obliged to disclose to the public every measure or sanction that would be imposed for infringement of the provisions adopted in the implementation of MiFID? Please explain the reasons for your views

Our members are in favour of consistent application of MiFID rules and therefore support administrative measures which have the effect of putting an end to a breach of the provisions of the national measures implementing MiFID.

- Administrative sanctions and periodic penalty payments must be proportionate and meaningful in order to be considered effective and dissuasive; however they must also be calibrated to take into account such factors as whether the breach was planned, deliberate or repeated, involved misrepresentations, was self reported, and whether actual damage was suffered by a third party.

- A minimum level of financial penalty may help move towards a more consistent regime but there is a risk numerical levels may have more or less significance in different jurisdictions. Whilst a broad EU-wide agreed framework on this issue would be helpful to achieve broad consistency of sanctions, it is important that national authorities retain jurisdiction and the ability to tailor judgements to the particular circumstances of the case.

- Criminal sanctions are the ultimate effective deterrent should therefore be available as a tool for prosecutors in the most serious infringements for both firms and individuals. The knowledge alone that criminal measures are available for the regulators to use, if effectively used, acts as a deterrent those contemplating wrongdoing.

- Consideration should be given to the variances in evidential burden required in different jurisdictions and the need for a more consistent and coherent criminal sanctions regime across Member States to risk arbitrage.European agreement in principle on what constitutes the most serious infringements that result in criminal sanctions would help ensure a level playing field across the EU.

Whilst a broad EU-wide agreed framework on this issue would be helpful to achieve broad consistency of sanctions, it is important that national courts retain jurisdiction and the ability to tailor judgements to the particular circumstances of the case. It is worth noting that in some jurisdictions, the UK for example, private warnings are given to individuals and firms by the competent authority where the rule breach is deemed to be of a more minor nature, the firm has taken full and immediate remedial action and where the competent authority considers it helpful to make an individual or firms aware that they came close to being subject to formal disciplinary action.

We believe national authorities should retain the ability to use sanctions such as private warning where it is appropriate to help ensure the regime is proportionate. The Commission (or ESMA) could give guidance on the types of circumstances where such warnings would be appropriate in addition to the areas

(138) In your opinion, is it necessary to introduce a third country regime in MiFID based on the principle of exemptive relief for equivalent jurisdictions? What is your opinion on the suggested equivalence mechanism?

Overall, we support efforts to foster a consensual approach within the EU and internationally. While we are unclear over the constitutional and legal rights/implications of denying EU member states their right to afford access based on a framework of exemptive relief (providing, of course, that it affords no greater right of access than would otherwise be available to firms / market infrastructures in other EU member states), we are deeply concerned over the language that appears in the fifth paragraph of section 8.3. This puts forward the proposition that any EU-wide mechanism for exemptive relief to firms authorised and established in third-country jurisdictions would be based only on a “strict equivalence regime”. Our understanding of a “strict” equivalence regime is that a third-country jurisdiction would need to have a set of rules that is essentially *identical* to the rules in effect within the EU in order for market participants to be granted access to EU markets. We believe that a test of equivalence should be based on whether or not the third country regime shares regulatory outcomes, standards, including in the areas of supervision and enforcement that are comparable to those in the EU.

The imposition of a strict equivalence regime in the EU would be open to third-country accusations of protectionism and could generate "tit for tat" responses when it comes to granting EU investment firms and market infrastructures rights of access into other jurisdictions. For example, the CFTC is reviewing its "no action" procedure, by which non-US exchanges (and MTFs) will be able to obtain access into the US. The suggestion that reverse rights of access into the EU will be allowable only on the basis of "strict equivalence" would encourage a similar attitude to be adopted by the CFTC and, in due course, by the SEC. This, in turn, would make it very difficult for the European Council to fulfil its recently-expressed intention on 16 September 2010 to *"take steps to, inter alia, secure greater market access for European business and deepen regulatory cooperation with major trade partners"* (Recital 32 in the 5 January 2011 Presidency Compromise Text for a Regulation on Derivative Transactions, Central Counterparties and Trade Repositories).

Such a "strict" approach will also preserve regional rules' differentiation and, by enhancing compliance with host-state rules rather than affording general recognition (where appropriate) of home-state rules, will complicate cross-border business and increase the risk of inadvertent breaches.

If, however, the Commission does introduce a third country regime, then it should:

- Take into consideration ongoing discussions with certain third party countries relating to mutual recognition (e.g. SEC);
- Establish a clear, centralised process for the assessment of third country firms to ensure consistency in such determination between Member States and prevent potential protectionism in approach by individual Member States;
- Determine the appropriate content for MOUs which would ideally operate at an EU level; if they need to operate at the level of Individual Member State level, then the Commission should ensure consistency;
- Address potential conflicts of laws and regulations between jurisdiction of third country firms and jurisdiction(s) of relevant Member States; and
- Clarify the scope of the concept to products issued by regulated entities in equivalent third countries as well as cross border provision of investment services;

(139) In your opinion, which conditions and parameters in terms of applicable regulation and enforcement in a third country should inform the assessment of equivalence? Please be specific.

Prior to the crisis, the EU-US Coalition on Financial Regulation (which is a transatlantic industry grouping of thirteen trade associations) put forward what it described as the three "gateways" to modernising and reducing the complexity of the regulation of cross-border business, namely:

(a) *Exemptive relief*, i.e. relief from compliance with host state rules in the case of foreign firms or issuers engaged in wholesale business or exchanges where the imposition of those rules would be unnecessarily duplicative or inappropriate, bearing in mind the nature of the counterparties and the business being undertaken;

(b) *Regulatory recognition* (which may be unilateral, bilateral or multilateral) i.e. acceptance by a host state regulatory authority of compliance by a foreign firm, issuer

or exchange with its home country licensing, prudential and business conduct rules on the basis of shared regulatory policy, principles and outputs

(c) *Rules' standardisation*, i.e. the development of common approaches, international standards and/or converged rules "targeted" to deliver simplified market/customer /provider access and incremental business efficiencies or where there is insufficient approximation in the output of rules to facilitate regulatory recognition;

The benefits of open rights of access and market liberalisation have a key part to play in driving recovery and, while the negotiating process is likely to be protracted (bearing in mind particularly unease in some quarters over market liberalisation as a result of the crisis), the following post-crisis policy statements should be taken into account:

- The European Commission emphasised in its October 2008 Communication "From Financial Crisis to Recovery: A European Framework for Action", *"the need to maintain the EU's commitment to open markets in trade and services and deeper multilateral cooperation, fighting against protectionist tendencies and pursuing a positive outcome of the WTO Doha Round"*

- The European Commission emphasised in its Communication "Driving European Recovery" (4th March 2009) that *"protectionism and a retreat towards national markets could only lead to stagnation, a deeper and longer recession and lost prosperity"* (page 11) and that *"an unequivocal message is essential to hold off these threats"* (i.e. *"domestic pressure to apply restrictive measures"*)

- The G20 leaders, in their Declaration following the June 2010 Toronto Summit, set out what they described as *the next steps we should take to ensure a full return to growth with quality jobs, to reform and strengthen financial systems, and to create strong, sustainable and balanced growth"* and, under the heading "Fighting Protectionism and Promoting Trade and Investment", emphasised the pivotal role played by open markets *"in supporting growth and job creation"* and invited the OECD, the ILO, WorldBank and the WTO *"to report on the benefits of trade liberalisation for employment and growth at the Seoul Summit"* (which includes trade in financial services). To that end, G20 representatives were directed to use *"all negotiating avenues"* to pursue the objective of bringing the WTO Doha Development Round to a *"balanced and ambitious conclusion as soon as possible"*.

For these reasons, we believe that the recognition standard of *"strict equivalence"* is misconceived and should be abandoned in favour of an approach based on shared regulatory outcomes, regulatory standards (e.g. in supervision and equivalence) and common public policy objectives and so accommodate a higher degree of rules' differences in attaining those outcomes.

(140) What is your opinion concerning the access to investment firms and market operators only for non-retail business?

Quite simply, if the framework of recognition can cover exemptive relief for retail business, why should access be denied to retail business? We recognise that the basis of recognition may have to be stricter in terms of, for example, investor protection requirements, disclosure obligations, etc., but there is no reason in principle why retail investors should be denied the opportunity of choice of providers, products or services?

Clearly, if the third country regime is deficient in the regulation of retail business and/or the protection of retail investors, but perfectly acceptable in terms of the regulation of non-retail business, then the framework of recognition could be restricted accordingly.

(141) [blank]

9. REINFORCEMENT OF SUPERVISORY POWERS IN KEY AREAS

(142) What is your opinion on the possibility to ban products, practices or operations that raise significant investor protection concerns, generate market disorder or create serious systemic risk? Please explain the reasons for your views.

(143) For example, could trading in OTC derivatives which competent authorities determine should be cleared on systemic risk grounds, but which no CCP offers to clear, be banned pending a CCP offering clearing in the instrument? Please explain the reasons for your views.

(144) Are there other specific products which could face greater regulatory scrutiny? Please explain the reasons for your views.

We would urge the Commission to delete 'product' from the list in question 142. If there are investor protection concerns the Commission should focus on enforcement of suitability requirements if the product wasn't suitable for the client or focus on the activity / behaviours undertaken which is given rise to perceived market disorder or systemic risk concerns

We consider that full use should be made of the enforcement of existing MIFID provisions (including, where appropriate, Lamfalussy Level 4 enforcement of Member States' implementation of the Directive) before consideration is given to the use of a power to ban practices or operations. A broad banning power should not be used as a substitute for proportionate rules specified in the Directive to govern behaviour.

If the Commission considers that it is necessary to use the proposed power to ban a practice or operation it must have a detailed consultation process, a clear and explicit policy as to when it can do this, a significant majority of the Member States most affected by the decision must agree to the decision, and firms must have the right to challenge/appeal the decision. Any proposed ban must be based on sound, objective judgment and not be caught up in political motivations. The Commission should guard against any attempt to create a 'zero failure' culture as that would impose unwarranted costs on European financial services and harm the EU's global competitiveness. It is important that these constraints on the use of the power are specified in the legislation.

Similarly, the circumstances when the Commission or national regulators could use emergency powers to ban or restrict investments or investment practices without consultation must be apparent and closely circumscribed. ESMA must take into account the implications for investors and issuers, and for the stability of EU markets and the EU economy, of banning products and investment services. A ban of a widely held product could lead to increased systemic risk. Additionally there are implications for portfolio valuations and retail clients' ability to liquidate positions.

It is also important to take account of the fact that many product markets are open 24 hours a day around the world. An EU ban could put EU investors at a disadvantage if third country markets can still deal in the stocks or shares. To this end we strongly urge that any decision to ban investments / services should be taken in conjunction with regard to what overseas regulators policies are, particularly regulators in the US and in Asia. Disproportionate powers or the potential for product intervention could discourage new entrants to the EU market which would reduce both EU competitiveness and investor choice.

In the context of question 143 such a power is not desirable as it would potentially create significant uncertainty and a risk of disruption to the effective functioning of the market. The decision whether a product is sufficiently suitable to be cleared should be determined by the CCP, who have the expertise to asses the product has the right criteria to be cleared

With reference to question 144, please see our response to question 105b. We believe that a false link is sometimes made between product complexity and product risk, which leads to the illusion that complex instruments are automatically high-risk instruments. Attempting to identify in advance products that warrant differentiated regulatory treatment could likely leading to insufficient regulatory attention being devoted to other supposedly 'less risky' products. We do not believe there are any other specific products which could face greater regulatory scrutiny as all other relevant products are being dealt with through other legislation.

Analysis of the impact of Commission proposals on EU markets, their users, and the EU economy
We are concerned that, unless they are very tightly circumscribed, the Commission's proposals could harm EU markets, their users (investors and issuers), and the economic interests of the EU, by introducing unpredictability to EU markets, and thereby deterring EU and third country issuers and investors from participating, and driving business to markets, perhaps in Asia, which offer greater certainty and stability.

Although the short consultation period has made it difficult/impossible to undertake a thorough assessment of the proposals, we have asked our Member firms to estimate the impact that the proposals, unless very carefully crafted and controlled, might have on the conduct of investment services and activities on behalf of investors and issuers. Please see our response to Question 105b. We believe that a false link is sometimes made between product complexity and product risk, which leads to the illusion that complex instruments are automatically high-risk instruments. Attempting to identify in advance products that warrant differentiated regulatory treatment could likely leading to insufficient regulatory attention being devoted to other supposedly 'less risky' products.

(145) If regulators are given harmonised and effective powers to intervene during the life of any derivative contract in the MiFID framework directive do you consider that they could be given the powers to adopt hard position limits for some or all types of derivative contracts whether they are traded on exchange or OTC? Please explain the reasons for your views.

Regarding position limits, we support the view taken by the FSA and HM Treasury in their joint paper on OTC derivatives[17] where they state that they have not seen evidence to indicate that a blanket approach through specific position limits is the most effective way to monitor, detect and deter manipulative behaviour in derivative markets, whether they are on-exchange or OTC. Nor is there any evidence which demonstrates that prices of commodities, or other financial derivatives, can be effectively controlled through the mandatory operation of regulatory tools such as position limits. The Commission should undertake further analysis to establish whether imposition of position limits would achieve the desired effect, and to ensure that there would not be unintended adverse consequences. We agree with the FSA and HM Treasury statement that a broader position management approach which does not focus on one type of participant would be the most effective approach to ensuring market integrity in derivatives markets.

[17] See www.fsa.gov.uk/pubs/other/reform_otc_derivatives.pdf

(146) What is your opinion of using position limits as an efficient tool for some or all types of derivative contracts in view of any or all of the following objectives: (i) to combat market manipulation; (ii) to reduce systemic risk; (iii) to prevent disorderly markets and developments detrimental to investors; (iv) to safeguard the stability and delivery and settlement arrangements of physical commodity markets. Please explain the reasons for your views.

Please refer to our response to Q.145

(147) Are there some types of derivatives or market conditions which are more prone to market manipulation and/or disorderly markets? If yes, please justify and provide evidence to support your argument.

We are not aware of any such products or market conditions.

(148) How could the above position limits be applied by regulators:
(a) To certain categories of market participants (e.g. some or all types of financial participants or investment vehicles)?
(b) To some types of activities (e.g. hedging versus non-hedging)?
(c) To the aggregate open interest/notional amount of a market?

Please refer to our response to Q.145

Annex 1: Case Studies

The following case studies illustrate the fact that exchange trading of derivatives is not always possible and that mandatory exchange trading of particular instruments could adversely impact the ability of market participants to manage risk.

Generic Interest Rate Swaps

Consider the case of a company that obtains floating rate financing, either in the form of a bank loan or by issuing a floating-rate note. This bank faces the risk that rising interest rates could sharply drive up its funding costs. In extreme circumstances, such an unhedged exposure might result in financial distress for the borrowing company. In fact, the company's loan or bond covenants will often require it to hedge its interest costs as condition of the loan.

The company could mitigate the interest rate risk by issuing fixed rate financing, but many companies find the added cost of issuing explicit fixed-rate debt prohibitive. Banks typically prefer to make floating rate loans because their own cost of funds are variable.

As things stand today, this company can easily hedge its interest rate exposure by entering into an interest rate swap with a maturity and scheduled payment (settlement) dates that match the scheduled payment dates on its obligations. But the company would lose this option if it were forced to rely on standardized, exchange-traded contracts. It would be infeasible for exchanges to offer a wide enough variety of contracts to provide the company in question with a tailor-made hedge. The Eurodollar interest rate futures contract, for example, is only listed for a limited number of expiration dates and maturities. Thus, any attempt to construct a hedge by selling a bundle of interest rate futures contracts would expose the company to considerable *basis risk*, manifested in this instance as the risk that interest rates could change between the maturity dates of the futures contracts and the scheduled interest payment dates.

To see why it would be infeasible for futures exchanges to offer a comprehensive range of standardized contracts, consider a *generic five-year interest rate swap*. The day after it is executed, this instrument becomes a four-year, 364-day swap. So to provide a liquid market for five-year interest rate swaps, the futures exchanges would need to offer a four-year, 364-day swap contract, a four-year, 363-day contract, etc., as well, because otherwise anyone who entered into the five-year contract would have no way of exiting the contract in the event of a change in circumstances. Assuming an average 250 trading days per year, exchanges would need to list 1,250 different contracts just to facilitate trading in 5-year interest rate swaps.

Is clearing feasible?

Yes. Generic interest rate swaps are simple to value and to risk manage and the underlying market is liquid. LCH.Clearnet, a recognized clearinghouse, has been clearing generic interest rate swaps since 1999. Today, LCH.Clearnet clears interest rate swaps in 14 currencies out to 30 year maturities and another 10 currencies out to 10 years. It also clears OIS contracts out to two years for four different currencies.

Is exchange trading feasible?

No. Listing all of the contracts currently cleared by LCH.Clearnet would require listing over 30,000 different contracts.

- Trading volumes on most of these instruments would not be sufficient to cover costs of listing the contracts so the practical effect of mandated exchange trading would be to severely limit the number of instruments available to hedgers.
- This is why futures exchanges currently only offer swap futures contracts and Eurodollar futures contracts (which can be used to mimic the payoffs to a small subset of available interest rate swaps), each offering at most 10 different expiration dates per year.

Consequences of Requiring exchange trading

A requirement to trade interest rate swaps on exchanges would likely limit trading to instruments with a handful of expiration dates, as is currently the case with swap futures and Eurodollar futures. This would expose corporate borrowers and investment managers to significant basis risk when attempting to hedge their interest rate exposures. Basis risk would arise because the exchanges would be unable to list contracts for all possible payment dates for all outstanding bonds and loans.

Interest Rate Caps

Consider the case of a company that obtains floating rate financing, either in the form of a bank loan or the issuance of floating-rate notes. The company is willing to bear a limited amount of interest rate risk, but is concerned that a sharp spike in interest rates might cause financial distress. In this case, the company could effectively cap its future interest rate costs by buying a bundle of interest rate options, called, appropriately enough, an *interest rate cap*, which would limit any future increases to its interest costs while permitting it to benefit if market rates were to fall.

Interest rates caps are traded over-the-counter in a wide range of maturities. In the OTC market, a hedger wishing to use interest rate caps can construct a perfect hedge matching the maturity of its outstanding debt and matching the option expiration dates precisely with its maturity dates.

The company could also hedge by buying standardized, exchange traded interest rate options from a futures exchange, but standardized options are not available for long maturities and the choice of expiration dates is extremely limited. Thus, any attempt to use standardized options would involve *basis risk*, the risk that the hedge payoffs would not match losses incurred on the underlying debt.

Is clearing feasible?

Perhaps. Although interest caps are not currently centrally cleared, it might be possible for the more standard types of structures. Valuation of caps struck on actively traded interest rates does not pose insurmountable problems, although the risk management of such positions would be more difficult than for generic swaps. It would probably not be feasible to clear all types of cap structures.

Is exchange trading feasible?

No, for the same reasons that exchange trading is not feasible for interest rate swaps. Like a five-year interest rate swap, a five-year cap becomes a four-year, 364-day cap the day after it is executed, a four-year, 363-day cap the day after, and so on. To provide markets for all possible interest rate caps—both active, current-dated instruments as well as previously executed deals—would require exchanges to list at least 10 thousand different contracts.

Consequences of mandating exchange trading

The consequences of mandating exchange trading would be the same as for interest rate swaps.

Amortizing Interest Rate Swaps

An *amortizing interest rate swap* is an interest rate swap in which the notional principal amount is reduced over time. Mortgage lenders use *amortizing interest rate swaps* to hedge the interest rate risk associated with pools of mortgages held from the time a loan is originated until they can be sold to a mortgage conduits such as Fannie Mae, Freddie Mac, or the Government National Mortgage Association (GNMA). In periods of significant interest rate volatility, the interest rate risk associated with holding mortgages can be considerable.

Amortizing swaps present a special challenge because not only does the maturity of an existing swap change over time, but so does the notional amount outstanding.

Is exchange trading feasible?

No. Although futures contracts on mortgage-backed securities were the first interest rate futures contract to be listed by a futures exchange, no futures contracts of this type currently trade on US exchange. The Chicago Board of Trade listed two different futures contracts for mortgage-backed securities (in 1975 and again in 1989) and both subsequently failed. Nor was this experience unusual. One analyst has estimated that between two-thirds and three quarters of all new futures contracts introduced by exchanges subsequently fail to attract sufficient interest to remain viable for the listing exchange.[18]

Post-mortem analyses of the fates of both contracts suggest that the problem was that market participants found that standardized contracts were not useful in hedging the highly idiosyncratic price risks associated with individual mortgage-backed securities: attempts to use such contracts to hedge the price risk associated with individual mortgage-backed securities left investors bearing too much basis risk to make reliance on the standardized contracts worthwhile. Listing a futures contract is only feasible in cases where the underlying commodity or asset can satisfy detailed and standardized written descriptions. In contrast, mortgage pools tend to be highly idiosyncratic in nature, with promised interest coupons and underlying borrower characteristics varying significantly from one pool to another. Thus, hedgers with exposures to pools of mortgage-backed securities turned instead to other instruments--first using Treasury Bond futures as an imperfect cross-hedge, and then later turning to tailored amortizing swaps and swaptions, which could be tailored more closely to the return characteristics of individual pools of mortgages.

Is clearing feasible?

It is not clear whether amortizing swaps could feasibly be cleared through a central clearer. LCH.Clearnet does not currently clear amortizing swaps. While the valuation of certain standardized types of amortizing swaps would be straightforward, hedgers typically wish to tailor the instrument to match the characteristics of their exposures. As noted above, mortgage-backed securities are highly idiosyncratic instruments whose payoff depends on the characteristics of an underlying pool of mortgages. This means that the underlying instruments themselves tend to be illiquid, which

[18] See William L. Silber, "Innovation, Competition and New Contract Design in Futures Markets," *The Journal of Futures Markets*; Summer 1981; pp. 123-155

makes it difficult to use market prices to infer values. The absence of market prices is especially significant in this case because mortgage-backed securities are notoriously difficult to value.

Consequences of mandating exchange trading

The consequence of mandating exchange trading in amortizing swaps would be to take away the best means available mortgage banks, mortgage brokers, banks and investors now have to hedge their exposures to the risks of holding pools of mortgages. It is likely that mortgage markets would become less liquid as a result, which would likely translate into higher mortgage rates for borrowers.

Hedging risk in emerging economies made possible through OTC credit default swaps

Over-the-counter derivatives have over the past three decades made it possible for businesses and governments to increase the control they have over the financial risks they encounter in their activities. Risks that were once considered an inseparable part of an activity can now be separated from the activity and managed effectively.

Banks have been important beneficiaries of over-the-counter derivatives in general and of credit derivatives in particular. Consider a European [Austrian/German] regional bank that has significant lending activities in its home region as well as in the emerging economies of Central and Eastern Europe. The bank has significant loan exposure to a local manufacturer that has recently undergone an unexpected change in management. At the time the bank made the loan, the manufacturer was judged a strong credit and unlikely to default. The new management, however, has expanded outside the region by acquiring other manufacturers, and the bank is now concerned that the risk of default has increased. In order to limit its exposure, the bank buys credit protection in the form of a credit default swap from a major European bank. If the borrower defaults, the seller of protection will compensate the regional bank for the loss. Although buying protection means paying away some of the loan income to the seller of protection, the lender will be protected against losses if the borrower defaults.

The same bank faces additional problems in connection with its Central and Eastern European credit business. On the one hand, the regional bank knows the market well and is optimistic about the long-term credit outlook for its borrowers. But on the other hand, its loan portfolio is beginning to appear concentrated in loans to that region and therefore exposed to an overall economic downturn. The solution appears to be to diversify the loan portfolio into other regions, but doing so in practice is difficult, primarily because the lender does not want to alienate its clients by reducing credit lines. As an alternative, the bank buys credit default swap protection on some portion of its Central and Eastern European loan exposure, although it does not hedge the entire amount. The result is that the regional bank has reduced its exposure to an acceptable level.

The above examples illustrate the two most important benefits of credit derivatives, namely, the ability to hedge against default and the related ability to reduce credit concentration. As these benefits became more widely known over the past decade, credit default swaps grew at a rapid pace, but have done so as over-the-counter, not listed, derivatives. Some argue, however, that the industry has now matured and that it is time for CDS to move from being privately negotiated to being executed on an organized exchange, with its accompanying benefits of higher transparency.

One might argue that CDS are well suited to exchange trading because they are among the most standardized of over-the-counter derivatives. Unique among OTC derivatives, CDS have shared standard settlement and maturity dates since 2004. Further, starting in 2009 CDS carried standardized fixed coupons and standard “look-back” effective dates, so that CDS have become even

more standardized over time. Given the uniformity of the CDS product, one might reasonably assume that CDS are a logical candidate for exchange trading.

Such an assumption is not unreasonable for CDS referenced to diversified indices such as iTraxx or CDX. Along with the standardized settlement and maturity dates and standard coupons mentioned above, index CDS reference a limited number of indices such as investment grade and high yield; Markit Group includes four of these indices in its list of the 450 most liquid CDS. Further, the index providers issue a new index every six months, so that at any given time there is by design only one liquid underlying index of each type. And finally, CDS are moving to central counterparty clearing. So least for the five-year CDS maturity, which is by far the most actively traded and liquid, it is conceivable that some index CDS trading could eventually move to exchanges.

But banks do not use CDS linked to indices to hedge their loan exposures; instead, they use 'single name' CDS protecting against default by a specific borrower. According to the Bank for International Settlements, about two thirds of outstanding contracts are single name CDS. And according to the Depository Trust Clearing Corporation Trade Information Warehouse database, single-name CDS are only about 30 percent of gross notional volume but they make up about 90 percent of the total number of trades in a week.

Single-name CDS share many significant properties of index CDS, namely, standard settlement and maturity dates and standard fixed coupons. But according to Markit Group, there are about 4,000 corporate credits on which dealers will quote spreads for default protection. The frequency with which they trade varies markedly. Second, single-name CDS differ according to seniority of underlying debt, which can be senior or subordinated. And finally, CDS for some names might trade in more than one currency, fragmenting the liquidity further. So given the diverse nature of single name compared with index CDS, it is unlikely that any but a few highly liquid names would generate sufficient trading interest to support exchange trading. The vast majority of others would have to remain over-the-counter.

But even assuming that a few single name CDS could sustain sufficient liquidity to survive as an exchange-traded product, the resulting product might be of little use for market participants seeking to hedge their bond holdings. One problem is matching the CDS to the maturity of the underlying. Five year CDS are most liquid and most likely to trade on exchanges, but creditors seeking hedges might need maturities more closely tailored to the bonds and loans they hold; this is especially critical for either banks that need to match the hedge maturity to obtain capital relief. Another is that constructing a hedge position from a relatively thinly traded name on an exchange could create significant market impact—that is, drive up the market price—which would reduce the effectiveness of the hedge. Finally, the price transparency afforded by the exchange is likely to be of little practical use to a bank seeking to hedge a specific, customized credit exposure.

Mandating exchange trading of single name CDS could therefore be counterproductive in two ways. First, it could restrict the availability of credit protection to a small number of bond issuers that attract sufficient interest to support exchange trading. Hedging other names would simply be impossible except through dealers in over-the-counter CDS. And second, a highly standardized exchange-traded CDS is unlikely to be a useful hedging tool except in those rare cases in which the underlying bonds correspond to the sizes and maturities of the available contracts. The regional bank mentioned above would therefore be deprived of a tool for managing its credit risks.

Mexico ensures sustainability of its public finances through an OTC oil hedge

As the Mexican economy become more integrated with the United States and Canadian economies, the Mexican government has set ambitious goals for improving the country's transportation infrastructure. In order to realize these goals, the government must maintain its capital spending even if the world economy slips into recession. But to meet its spending goals, Mexico depends on revenues from sales of crude oil staying above a particular level. The result is that government spending projections assume that oil prices stay above an assumed minimum level.

In order to maintain the pace of its infrastructure improvements, the Mexican government decided in both 2008 and 2009 to protect against falling crude oil prices by purchasing over-the-counter options—known as put options—giving Mexico the right but not the obligation to sell crude oil at an agreed 'strike' price at regular intervals during the year. The strike price of crude oil agreed at the end of 2008 was $70 per barrel and at the end of 2009 was $57 per barrel; these prices correspond to budget projections. Although the price of Mexican crude oil is generally lower than the world price, the Mexican and world prices tend to move together so that a fall in one means a fall in the other. If the world oil price falls below the strike price during the term of the option, the financial institutions that sell the option will compensate the Mexican government for the amount by which the price of oil falls below the strike. But if the price of oil rises instead of fall, the parties to the options face no obligations.

This protection is not free: Mexico paid its financial institution counterparties a total of $1.5 billion for the options in 2008 and $1.2 billion in 2009. The government is willing to pay the fees because it believes that the potential loss of revenue if oil prices fall is far greater than the cost of the options themselves. And if prices rise, there will be no further fees to pay.

The options described above are over-the-counter options. But listed futures on crude oil are widely available in a liquid, transparent market. And listed options on crude oil—on crude oil futures, to be more precise—are also widely available. So why did the government choose OTC instead of listed options?

A major reason is size of the transaction. The large volumes of oil to be hedged are more easily addressed in the flexible OTC market, which permits contract terms to be customized to the client's precise needs. Listed contracts, in contrast, have fixed sizes and maturities and tend to be smaller in volume; Mexico would have had to purchase a huge number of such contracts. In addition, a trade of this size on an exchange would, because exchanges offer a high degree of transparency, signal to the entire market that someone is executing an unusually large hedge on an obviously large position. This would be true even if the hedge were divided among several dealers. In response, some active traders could try to position themselves to benefit from this large trade, with the consequence that the oil price and option premium move in an unfavourable direction—that is, crude oil moves downward and the cost of the put option moves upward—before the government and its dealers finish setting up the hedge.

Mexico's hedging activities illustrate vividly the 'market completion' benefits of over-the-counter derivatives. That is, although derivatives meeting the specific hedging needs were not available on exchanges, the government used its relationships as a client with its dealer banks to access indirectly the listed markets. That is, the dealer banks took on the oil price risk and volatility from Mexico, but then turned around and hedged these risks with other counterparties so that their own books were 'flat' overall. It is likely that a large proportion of these dealer hedges were transacted on exchanges, illustrating how over-the-counter products 'complete' markets by providing a link between large, customized clients such as Mexico with liquid, transparent markets such as those offered by exchanges. If over-the-counter hedges were not available, hedging would be less precise and more

costly than it is now. In such a case, it is likely that Mexico and clients like it would be less inclined to hedge and would consequently face greater uncertainty in their economic development.

European aircraft manufacturer eliminates currency risk through unique properties offered by OTC derivatives

A European aircraft manufacturer faces two risk management problems in its dealings with a U.S. airline. The first is that the manufacturer has agreed to deliver an aircraft to the airline for a price of $70 million, due in thirty days. At current exchange rates, this price will cover the manufacturer's costs of €50 million. The problem is that the dollar might fall against the euro over the next month, so that the dollar price received will no longer cover the cost of the aircraft.

In order to manage this foreign exchange risk, the manufacturer and its bank enter into a EUR/USD currency forward. Under the terms of the agreement, thirty days from today the manufacturer will pay $70 million to the bank and the bank will pay €50 million to the manufacturer. The result is that the manufacturer has transferred its currency risk to the bank by locking in a euro-dollar exchange rate. There is no fee for the transaction. Although the manufacturer runs the risk of losing the benefit if the dollar were to rise instead of fall, the manufacturer is more concerned with cash flow predictability than with making money from currency movements.

A second problem is with a bid by the manufacturer in response to the airline's request for bids on a new aircraft line, to be awarded in three months. The manufacturer's bid price is based on current EUR-USD exchange rates. But the manufacturer faces the risk that, if successful, the dollar falls against the euro before the award so the dollar price no longer covers costs. The currency forward suggested above would not be a feasible solution in this case because the manufacturer would be obligated to deliver currency on the settlement date.

Instead, the manufacturer decides to purchase a foreign exchange option from its bank. To be specific, it purchases a dollar put option that gives the manufacturer, in exchange for payment of a fee, the right but not the obligation to deliver an agreed amount of dollars to the bank in return for an agreed amount of euros. If the dollar falls and the manufacturer wins the bid, the manufacturer exercises the option and makes the exchange of currencies. But if the bid is unsuccessful, or if the bid is successful but the dollar does not fall, the manufacturer does not exercise the option so no further payment is required.

The above two transactions, which substantially reduce the manufacturer's financial risks, would almost certainly be negotiated privately—that is, over-the-counter— and not on an exchange. Further, it is likely that, if standardized exchange traded contracts were the only currency risk management tools available, neither of the above hedge transactions would have taken place. The result is that the manufacturer would have faced higher foreign exchange risks and, in the face of these risks, might cut back on pursuing opportunities overseas.

Almost all foreign exchange activity occurs in over-the-counter markets: according to the Bank for International Settlements, exchange-traded FX derivatives activity is about one half of one percent of all FX derivatives activity. Further, a significant share of FX activity occurs because of commercial activity; one estimate puts commercial activity at about 75 percent. The significance is that the majority of FX activity occurs because of hedging needs. And as the above example suggests, nonfinancial corporations in particular are significant users of FX products and use the products for a wide array of purposes: examples include, among others, financing exports and imports, making payments to foreign suppliers, repatriating earnings from foreign operations, investing in overseas

plant and equipment, and acquisitions of foreign businesses. All these activities can involve substantial exposures to movements in exchange rates, and lead to demand for hedging products. These activities also involve a diverse array of cash flows, occurring in a wide range of sizes and at varying times; hedging these cash flows requires a high degree of customization. That is why businesses find over-the-counter FX products useful to hedge their activities.

Exchange-traded derivatives, in contrast, are by necessity highly standardized, and their terms include standard underlying amounts and settlement dates. Such standardization has benefits: it facilitates trading, for example, by concentrating liquidity in a small number of standardized contract types. But standardization also has its costs: as mentioned above, corporate hedging needs are diverse and are unlikely to fit standardized contract templates. The aircraft manufacturer would likely find it difficult if not impossible to match the exposures to hedges offered by exchanges; in other words, the hedge would be weakened by the "basis risk" arising from mismatches between the derivative and the underlying exposure. In addition, exchanges have formalized, mandatory risk management procedures such as initial and variation margin requirements. A non-financial corporation such as the aircraft manufacturer might keep most of its working capital tied up in production and therefore face additional funding costs just to keep cash reserves available to respond to margin calls.

So if FX hedging products were limited to those that trade on exchanges, businesses would lose many of the benefits of hedging because of standardization and would face increased costs of hedging because of cash margin requirements. Many of these business would then decide that the costs of hedging exceed the benefits and would therefore cut back their hedging activities, which means greater currency exposures. Or alternatively, firms will avoid those activities involving currency exposures, turning instead to less productive uses of their resources. Either outcome means weaker economic performance.

Annex 2: Pre-trade transparency in OTC derivatives markets

Credit Default Swaps

A range of services exist on the market that receive and organize the market quote data to provide to market participants through easily accessible services, thus making a high level of pre-trade information available to the market:

- **Widely disseminated dealer pricing "runs":** Each client receives runs from multiple dealers, i.e. clients have access to a wider range of prices than the dealer participants who only have access to their own levels. Clients then raise RFQs to the various dealers from which they wish to receive competing quotes. Although the runs prices are not executable, dealers face reputational issues if they do not stand behind their run prices and they therefore have a commercial incentive to ensure that they are willing to execute within the bid offers sent via the runs.
- **Parsing services**: organize and present the dealer runs in an easily accessible format, creating stacks displaying best price and depth of quotes (with time and ownership stamp of each price point). The parsing services may be available for free or for a fee from commercial vendors, to any market participant or other entity wishing to gain access to the data. Some of the vendors that provide CDS parsing services include Bloomberg, Markit, and CMA/ QuoteVision/ DataVision.
- **Bids wanted in competition/Offers wanted in competition:** These lists of positions are sent by clients to multiple dealers to seek competitive bids in order to achieve the best possible price.
- **Single Dealer screens/ electronic services**
- **Commercial vendors also provide daily mid market intra-day and end of day pricing** based on levels aggregated across various dealer providers. These levels are not executable but provide an indication of the market. Vendors include Markit, Bloomberg and CMA.
- **CCPs provide end of day marks for contracts that are eligible to be cleared.** The CCP end of day process typically requires executable pricing from all participating members and produces a composite price based on each CCP's proprietary algorithm. The executable pricing data provided to the CCP's for this calculation is comprehensive incorporating all points on the CDS curve. Members are typically required to trade on a regular basis to guarantee robustness of the CCP end of day price. The cleared set of European CDS contracts already includes 7 of the most recent European High Grade and High Yield CDS Index Series, as well as Single Name CDS that cover approximately 85% of the constituent entities of the main European CDS Index, as at the end of May 2010. As the set of cleared CDS products is expanded this year, the CCP's end of day pricing process will grow to cover virtually all CDS on liquid indices and single name components of the indices.
- **Electronic execution platforms** (mainly Bloomberg Single Dealer services) exist on the end user side, providing the ability to view live prices from multiple dealers and to raise either RFQs or orders.

Interest Rates

Of the OTC asset classes, we believe the Interest Rates Derivatives is a market that already provides excellent pre-trade transparency and we don't believe there is any need for radical change. Counterparties are able to access a number of sources for price discovery allowing counterparties to achieve competitive pricing. Also, for large trades or clients, discretion is of paramount importance. Owners of large risks (pension funds, money managers, etc.) are very sensitive to the market gaining

awareness of their risks. In addition, occasional large corporate flows are executed and we observe that clients prefer discrete venues for execution in order to keep financing costs and risks low.

Global Regulators targets encourage a further move towards making the market more electronic, the competitive dealer platforms continue building and improving information and tools for end users.

Equity Derivatives

For vanilla OTC products in respect of which a pre-trade transparency regime exists for an equivalent Exchange-traded derivative, if a specific pre-trade transparency regime should be defined, then this must not impose more constraints than the one existing of the existing exchange-traded derivatives markets. We note in this regard that liquidity in Exchange-traded derivatives is often sourced in the OTC market via a price-request mechanism, and only after the trade has been agreed is it then reported to the Exchange and given up to the clearing house.

For non-vanilla equity OTC products, defining a pre-trade transparency regime would be much more challenging, as these products by their nature are made-to-measure and do not exist until a specific price request has been made. Imposing a pre-trade transparency regime could consequently substantially impair the bespoke market and consequently hinder investors' ability to hedge a specific risk or to take on a specific indexation.

Commodity Derivatives

Pre-trade information is consolidated via exchanges, electronic trading platforms and major dealer pricing information. There is already a highly developed exchange-traded market with high levels of consolidated pre-trade transparency. Further, these contracts act as bench marks will be used to manage the market risk arising from the provision of bespoke OTC commodity derivatives hedging solutions to end users. At present, there does not seem to be demand for additional pre-trade transparency for non-standardised OTC deals which are frequently so customised that additional information would not add materially to the price discovery process.

Pre-trade information for these bench mark contracts is also available via other bodies such as Thomson Reuters and Bloomberg which provide information services to the wider market. The bench mark contracts are supplemented by broker screens and voice brokers which provide pre trade transparency to market participants on the relevant OTC commodity derivatives, including:

- UK and European gas and power;
- Emissions;
- Coal;
- Freight; and
- Oil Products.

In addition entities such as Platts and Argus provide transparency windows for certain OTC commodity derivatives (mainly crude oil and crude oil products) covering swaps, CFDs, ‘forward curves’ and price indices at specific times of the day which provide pre trade information to market participants in those products.

Foreign Exchange Derivatives

Transparency is arguably no issue in principle for FX and the FX market already benefits from a high degree of pre-trade transparency. Furthermore, an important way in which FX dealers compete with each other is through the range of contracts they are able to provide to their clients electronically, and this is continually pushing back the electronic frontier. At least for the FX market, a formal "regime" does not therefore seem necessary.

However, if a formal regime is nevertheless imposed, it must take into account at least the following points:

- Streaming prices versus RFQ. With current technology it is only practicable to broadcast continuously updating prices (real time streaming) in a finite number of contracts. In practice, for most market makers this tends to mean spot FX and the most common FX forwards, according to the power of their technology platform. All other contracts (which are necessarily infinitely variable in currency exchange) are priced on a Request-for-Quote basis, i.e. only upon client demand. If a regime involves any obligation to make "continuous" prices in FX it must take these practical constraints into account.

- Diversity of pricing venues. There is currently a lot of choice and competition in the FX market in the area of pre-trade price discovery, as described above. If a transparency regime goes in the direction (intentionally or otherwise) of mandating a single "official" venue then this is likely to consolidate leading to less choice for participants.

If an on-exchange/ anonymous type pre-trade transparency regime were introduced we believe that there is a genuine risk that this would lead to less liquidity in the FX markets. FX Dealers have direct relationships with their clients and therefore, are more likely to provide them with liquidity even during times of extreme market stress thus alleviating potential problems in this asset class and indirectly other asset classes as demonstrated during the credit crisis. Were an exchange-style solution (anonymous both pre- and post-trade thereby destroying bank-to-client relationship and implied obligation to quote) be introduced, we believe this would lead to a loss of liquidity especially when most needed in times of market stress.

Annex 3: Post- trade transparency in OTC derivatives markets

In addition, we have provided further comments for individual asset classes below. Please also see the ISDA/AFME/BBA Joint Response to CESR in the context of its Technical Advice to the Commission on non-equity transparency.

Credit Default Swaps

As a general principle, thresholds for CDS should be no more constraining than those relating to the related 'underlying' asset class. There is no point in applying a more demanding threshold for a market where the 'open interest' (i.e. the net amount that would change hands upon a credit event) is so clearly much smaller than that of the related 'cash' market; and where the risk that is taken on is subtly but importantly different (reflected in the fact that CDS prices do not move in lock-step with bond spreads – what is referred to in the market as 'basis').

Interest Rate Derivatives

Of all the derivatives markets the Interest Rates Derivatives market is the most liquid and that liquidity is reflected in the tight bid offers that allow end users to trade at a marginal cost from mid-market. The current bid/offer on a $100 million 5 year swap is less than ½ basis point or $23,000. The liquidity is a by-product of the increasing pre trade transparency that characterizes the market. As a direct consequence of that liquidity, and the tight bid/offer it implies, dealers are able to work orders at tight margins thus minimizing end user costs. Any post trade transparency that endeavours to disclose trade positions and sizing in the market will jeopardize liquidity and only result in higher end user costs. The introduction of post-trade transparency and consumer protection safeguards may prove to be detrimental to the end users they are trying to protect.

It is imperative that when setting a post-trade transparency framework we are sensitive to confidentiality and the impact disclosure could have on liquidity. It is necessary that we set general guidelinse of delaying and aggregating trade reporting of inter-dealer trades only in order not to adversely impact end users.

In addition, if we were to set a post-trade reporting framework, the details of the reporting should be flexible to market conditions to avoid any negative convexity whereby the detrimental impacts on liquidity of the post-trade transparency regime could become greater in times of stress.

Equity Derivatives

The creation of an OTC derivative Trade Repository for equities will provide full transparency to supervisors and an aggregated level of transparency to the public. However, it is important to bear in mind the private nature of these transactions in any consideration of a post-trade transparency regime.

As a general rule we consider that there is not a consistent desire from users for post-trade transparency. Many large end-users have voiced concerns that publication of trade-level information could give other participants unnecessary insight and information into their investment strategies – impairing the functioning of the market to the detriment of all participants. In addition, the market liquidity relies on the willingness of dealers to commit capital, and this could be significantly compromised if transactions were to be made public. Any consideration of a post-trade

transparency regime would have to carefully balance the perceived benefits against the interests of users in maintaining confidentiality and liquidity. In all cases, care must be taken that for large transactions the ability to execute should not be damaged. We note in this regard that CESR's July 2009 communication recognises this.

For vanilla OTC derivatives in respect of which a post-trade transparency regime exists for an equivalent Exchange-traded derivative, any consideration of a post-trade transparency regime must not impose more constraints than the one existing of the existing Exchange-traded derivatives markets. We note in this regard that existing Exchange-traded derivatives markets in Europe already impose limitations on post-trade transparency:

- Eurex non-disclosure on large-sized trades (Eurex circular 236/09) under BaFin regime;
- Bclear No-Posting option (London Notice No. 2697, section 2.1e) under FSA regime.

For non-vanilla OTC derivatives public disclosure would be complex to disseminate intelligibly and could compromise client or product confidentiality.

For vanilla options more post-trade transparency may be beneficial so long as there is a sufficient gap between report and trade. However, very large trades create added risk for the counterparty providing liquidity because the post-trade information may affect ability to hedge.

Commodity Derivatives

The OTC Commodity Derivatives market already provides central clearing for swaps that are suitable to be centrally cleared and a significant percentage of Commodity products are already efficiently processed and cleared. Most commodity exchanges and MTFs will already publish post trade information on a transactional basis and consequently further regulatory action is not needed. Brokers already offer post trade information for brokered OTC transactions. Publishing post execution data on bespoke OTC contracts without unintentionally disclosing sufficient information for market participants to identity the trade parties is very difficult and because of the tailored nature of these transactions they would not provide any useful price formation information nor serve any other price transparency policy objective. The volume of bilateral OTC trades only accounts for a small portion of the market.

Protecting commercially sensitive information is an important consideration for post-trade transparency requirements. An obligation should not be established in such a way that individual companies can be easily identified, as this could give market competitors not only visibility of the individual transactions for individual entities but also an insight into corporate strategy.

Foreign Exchange Derivatives

Any post-trade transparency regime in the FX market would consider the following:

- **Avoid damaging liquidity in less liquid FX instruments.** The trade-off between transparency and liquidity is well documented across many asset classes; too much transparency in less liquid areas of the market tends to inhibit market makers from taking on and warehousing risk, to the detriment of end users. This applies equally in the FX market, particularly in some less liquid areas of the forwards and options markets

- **Avoid "flash crash" runaway price moves in liquid FX instruments.** The rise of automated algorithmic trading, especially in spot FX, has made the markets exceptionally sensitive to price and trade data; a client with a $10m order may find the market running away from him when he has executed barely half of it. Providing real time post-trade data in this environment will give algo engines more data to feed upon and may exacerbate this problem significantly.

APPENDICES

Joint AFME/ASSOSIM/BBA/ISDA/NSA submission to the IOSCO Task Force on OTC Derivatives Regulation: Exchange and Electronic Trading

Joint ISDA/SIFMA paper on block trade reporting for OTC derivatives

Joint AFME/ISDA/BBA/ICMA response to CESR Technical Advice to the European Commission in the context of the MiFID Review: Client Categorisation, http://www.afme.eu/AFME/Policy_and_Advocacy/AFMEISDAICMABBAResponsetoCESRreClientCategorisation4August2010final.pdf

Joint AFME/BBA/ISDA response to CESR Technical Advice to the European Commission in the Context of the MiFID Review: Non-equity markets transparency, http://www.isda.org/c_and_a/pdf/JointResponse-CESR.pdf

ISDA Response to CESR on Consultation on guidance to report transactions on OTC derivative instruments, http://www.cesr-eu.org/popup_responses.php?id=5320