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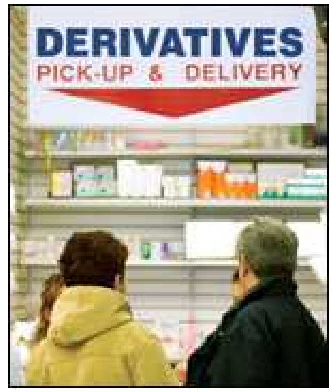
Over-the-counter and over here?

Organised platforms that could be used for derivatives trading, central clearing and minimising regulatory arbitrage. The OTC derivative debate continues apace



The Technical Committee of the International Organisation of Securities Commissions (IOSCO) has published a report on the trading of OTC Derivatives.

The report analyses the benefits, costs, and challenges associated with increasing exchange and electronic trading of over-the-counter (OTC) derivative products and contains recommendations to assist the transition of trading in standardised derivatives products from OTC venues onto exchanges and electronic trading platforms (organised platforms) while preserving the efficacy of those transactions for counterparties.

"The recent financial crisis revealed certain deficiencies in the OTC derivatives markets. To help address these deficiencies, the G-20 Leaders in September 2009 stated that "[a]ll standardised OTC derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest" in order to improve transparency, mitigate systemic risk, and protect against market abuse in the derivatives markets," the report said.

The report identifies seven characteristics of organised platforms:

"MEMBERS OF THE TASK FORCE WERE NOT IN FULL AGREEMENT AS TO WHETHER ORGANISED PLATFORMS MUST EXHIBIT ALL EIGHT CHARACTERISTICS IN ORDER TO ACHIEVE THE G-20 LEADERS' OBJECTIVES AND PROTECT AGAINST MARKET ABUSE IN THE DERIVATIVES MARKET."

- Registration of the platform with a competent regulatory authority, including requirements relating to financial resources and operational capability;
- Access for participants based on objective and fair criteria that are applied in an impartial, non-discriminatory manner;
- Pre- and post-trade transparency arrangements which are appropriate to the nature and liquidity of the product and the functionalities offered by the platform;
- Operational efficiency and resilience including appropriate linkages to post-trade infrastructure and measures to handle potential disruption to the platform;
- Active market surveillance capabilities, including audit trail capability;
- Transparent rules governing the operation of the platform; and
- Rules that do not permit a platform operator to discriminate between comparable platform participants in relation to the interaction of buying and selling interests within the system, whether fully electronic or hybrid.

In addition, the Task Force identified an eighth characteristic that would provide benefits over and above the seven characteristics just described, but also would generate additional costs:

The opportunity for platform participants to seek liquidity and trade with multiple liquidity providers within a centralised system.

However, the report did admit that members of the Task Force were not in full agreement as to whether organised platforms must exhibit all eight characteristics, or only the first event characteristics, in order to achieve the G-20 Leaders' objectives of improving transparency, mitigating systemic risk, and protecting against market abuse in the derivatives market.

"DEALERS WILL BE SUBJECT TO NEW CAPITAL AND MARGIN REQUIREMENTS AND IT IS WIDELY EXPECTED THAT THEY WILL PASS THEIR OWN MARGINAL COSTS ONTO THEIR CLIENTS."

"While many Task Force members believe that the opportunity to seek liquidity and trade with multiple liquidity providers must be offered within a centralised system in order to realise the G-20 Leaders' objectives, some members believe that benefits can be realised where the opportunity to seek liquidity and trade with multiple liquidity providers is offered within a product market as a whole, irrespective of whether a particular platform offers access to multiple liquidity providers," the report said.

"The Technical Committee said it recognises that, if some jurisdictions choose to establish requirements that give effect to all eight characteristics, while other jurisdictions do not, the resulting regulatory disparities have the potential to influence market participants' choice of venues in which to conduct business."

Dany Masri, the Managing Director of MARISK Consultants in Abu Dhabi believes that the upcoming new rules governing the trading of derivatives (Dodd-Frank, EMIR) will do little to enhance transparency for most corporate end-users as regulators are unlikely to require dealers to report detailed information about OTC contracts to be useful in benchmarking pricing.

"With such additional regulation that will add a new layer of complexity to derivatives pricing, not to mention next year's Basel III accords, dealers will be subject to new capital and margin requirements and it is widely expected that they will pass their own marginal costs onto their clients. It is clear that banks are going to charge more and find new ways to make money on derivative transactions," Masri said.

Asked about what it meant for the Middle East, Jeff Singer, the Chief Executive of NASDAQ Dubai said, "The equity derivatives market in the Middle East is in its infancy, but has huge potential as investors need to hedge their equity positions just as they do in other parts of the world."

"WHILE MANY TASK FORCE MEMBERS BELIEVE THAT THE OPPORTUNITY TO SEEK LIQUIDITY AND TRADE WITH MULTIPLE LIQUIDITY PROVIDERS MUST BE OFFERED WITHIN A CENTRALISED SYSTEM IN ORDER TO REALISE THE G-20 LEADERS' OBJECTIVES."

The report also deals with the much-anticipated aspect of regulatory arbitrage. Analysts and industry pundits have been warning about the possibility of widespread regulatory arbitrage since the dark days of the aftermath of the collapse of Lehman Brothers and the apparent kneejerk reactions by regulators.

Rodgin Cohen, one of the key figures during the grim days when regulators desperately tried (and failed) to keep Lehman alive and prevent Goldman Sachs, Morgan Stanley and even Citi fall in domino fashion behind it has long been warning of the risks of regulatory arbitrage.

"Activity will flow to a point where it can be conducted with the least constraints and there is a danger of regulatory arbitrage," he said.

The report emphasises that the transition of derivatives trading from OTC to organised platforms must be undertaken in a manner that minimises the potential for regulatory arbitrage.

"Each of the actions described … involves a level of judgment by regulators and would require regulators to consider a number of factors, as well as the views of market participants and market data. In carrying out any of the actions set forth above, market regulators should attempt to coordinate their efforts as much as possible in order to lessen the risks of uneven implementation across jurisdictions, thereby reducing the scope of regulatory arbitrage and its potential to weaken the regulatory scheme," the report says.

"While there is debate amongst regulators regarding the characteristics that an entity should exhibit to qualify as an eligible organised platform, the overriding principle that regulators must observe is that they need to coordinate their efforts in facilitating the transition of OTC derivatives trading to organised platform trading to ensure that the objectives of the G-20 are achieved, and not undermined," Hans Hoogervorst, the Chairman of IOSCO's Technical Committee, said.