

15 September 2006

International Swaps and Derivatives Association

Response to Call for Evidence

Pre- and post-trade transparency provisions of the Markets in Financial Instruments Directive (MiFID) in relation to transactions in classes of financial instruments other than shares

The International Swaps and Derivatives Association (ISDA) welcomes the opportunity to respond to the Commission's call for evidence in advance of its proposed report under article 65(1) MiFID addressing the possible expansion of pre- and post-trade transparency requirements to transactions in classes of financial instruments other than shares.

ISDA, which represents participants in the privately negotiated derivatives industry, is the largest global financial trade association, by number of member firms. ISDA was chartered in 1985, and today has over 725 member institutions from 50 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.

In this response, we focus on those issues raised by the call for evidence which are particular to over-the-counter (OTC) derivatives. In addition, we support the joint response of a number of industry associations, including ISDA, dated 15 September 2006 attached as Annex A (the Joint Response) which deals with the more general issues raised by the call for evidence across the wider range of asset classes.

ISDA believes that mandated transparency requirements would not help and are likely to harm the efficiency of OTC derivatives market activity. ISDA believes that, before imposing a regulatory solution, it is essential to demonstrate that a market failure has occurred and that, so far, there has been no evidence of market failure in the OTC derivatives market. Even if such evidence were found, however, it would not be sufficient to warrant a regulatory solution: It is also necessary to demonstrate that the mandated solution is likely lead to an improvement over the current state, so that regulatory intervention is limited to cases that are justified by a cost-benefit analysis.

ISDA also would emphasise the need to focus on optimal instead of absolute levels of transparency. Transparency is not an end in itself, but a means to the end of market efficiency. Various market structures have evolved, some highly transparent and some hardly transparent at all, for the purposes of capital raising and risk shifting; each market structure reflects the optimal level of transparency and other attributes appropriate to a particular market segment. Mandating high transparency for all markets, especially in markets that rely heavily on private information, could lead to less efficient markets and to reduced availability of essential forms of financial intermediation. Furthermore, mandated transparency could, by means of increased cost

to market participants, short-circuit the evolution of beneficial forms of transparency that respond to market demands. The following analysis proceeds in four stages:¹

1. Identification of alternative policies
2. Specification of subjective criteria for evaluating the alternative policies
3. Positive analysis of the economic welfare implications of alternative policies
4. Identification of the alternative that produces the greatest social welfare

Following the analysis, the comment will address the specific questions posed in the Call for Evidence.

With regard to the first stage, the Call for Evidence (Questions 15 and 16) specifies four policy options, namely, no change, self-regulation, mandated immediate transaction reporting, and mandated delayed reporting. ISDA believes that these proposed categories involve a level of detail that is premature and that the relevant policy choice is between more fundamental alternatives. ISDA therefore suggests that the relevant policy alternatives can be simplified to the (1) the “no change” alternative of allowing market participants to decide the level of transparency, and (2) the alternative of mandating a level of transparency, regardless of whether it occurs through a self-regulatory or a governmental channel. The analysis concerns only privately-negotiated, over-the-counter derivatives such as interest rate swaps and credit default swaps and does not attempt to address cash instruments or any other alternative specified in Question 2.

With regard to the second stage - the criteria for evaluating the alternatives - the primary welfare criterion will be the effect of a policy on OTC derivatives market efficiency. Market efficiency in turn can be broken down into two components, price discovery and liquidity. As discussed below, price discovery is of limited relevance to OTC derivatives because the price discovery function in relation to OTC markets is often performed primarily in other economically related markets such as futures markets or the market for the underlying instrument. Liquidity, on the other hand, is an important market characteristic because it has both private benefits and social benefits for market participants. The private benefits accrue especially to businesses, governmental entities and individuals seeking to hedge their risks; the social benefits occur in the form of enhanced financial stability.² The policy analysis will therefore evaluate policy options primarily by their expected effect on market liquidity.

The following analysis considers the economic welfare implications of market-determined versus mandated transparency.

Higher transparency does not necessarily mean higher social benefits

¹ This framework follows the normative welfare economic analysis suggested in L. Harris, *Trading and Exchanges: Market Microstructure for Practitioners* (Oxford University Press, 2003), Chapter 8.

² M. O'Hara, Liquidity and 'Financial Market Stability.' National Bank of Belgium, Working Paper No. 55, May 2004.

In an experimental analysis of the welfare effects of transparency in markets, Robert Bloomfield and Maureen O'Hara find that, while transparent markets tend to exhibit higher informational efficiency than non-transparent markets, "the enhanced informational efficiency is purchased at the price of greater transactional inefficiency."³ In other words, transparent markets have more informative prices but they also have wider spreads and higher trading costs. The implication of their analysis is that the winners from transparency are market makers, while the losers are "traders with immediate liquidity needs," which would include hedgers and other users. They conclude that "transparent markets need not be more efficient, nor does transparency necessarily enhance market competitiveness."

Transparency is beneficial to price discovery, but can reduce liquidity

The studies that support increased transparency generally do so on the premise that the primary criterion for evaluating market efficiency is price discovery.⁴ Under that criterion, transparency is preferred because it increases the speed with which prices reflect available information. Studies generally acknowledge, however, that transparency comes at a cost and can lead to lower liquidity. The search for an optimal level of transparency therefore becomes in most analyses a search for balance between efficient price discovery and liquidity.

It is not clear, however, that the trade-off between transparency and liquidity is of primary relevance to over-the-counter derivative market. The reason is that price discovery is generally not a primary function of OTC derivative markets.⁵ Most OTC markets appear to exist primarily as a flexible means of risk transfer. Price discovery, while important to OTC markets, generally takes place in other, complementary market structures. Interest rate derivatives, for example, depend on interest rate futures markets as well as money markets for price and yield curve information. Similarly, OTC commodity derivatives depend almost entirely on futures prices for pricing information.

No "one-size-fits-all" model of transparency

ISDA opposes any type of "one-size-fits-all" model of transparency, and believes that each sphere of financial intermediation requires its own optimal level of transparency. Financial intermediation consists of a vast array of institutions and markets, which have evolved in response to market demands for capital raising and risk shifting services in various environments. Considered from the point of view of transparency, financial markets span a continuum from highly transparent to hardly transparent. The continuum is shown in the following table.

³ R. Bloomfield and M. O'Hara, "Market Efficiency: Who Wins and Who Loses?" *Review of Financial Studies* (Spring 1999), pp. 5-35.

⁴ M. O'Hara, *Market Microstructure Theory* (Blackwell, 1995), pp. 252-260.

⁵ "Over-the-Counter Derivatives Markets and the Commodity Exchange Act." Report of the President's Working Group on Financial Markets, November 1999.

	Low transparency (Private information)			High transparency (Public information)	
Capital raising	Bank lending	Loan sales	Securitisation		Securities underwriting
		Loan syndication	Private placement	OTC securities markets	Securities exchanges
Risk shifting	Insurance	Swaps and other OTC derivatives	ATS?		Futures exchanges

All the points on the continuum represent responses to market demands at some point. Even those highly regulated market forms, such as securities and futures exchanges, arose originally not as the result of regulatory fiat but from the demand of market participants for specific forms of financial intermediation. Regulatory intervention that ignores the essential differences between the markets and the nature of the services they provide could reduce the options available to users of financial services.

At the right end of the continuum are the high transparency markets. For capital raising, these include the public securities underwriting process and the securities exchanges; for risk shifting, they include the futures exchanges. A securities exchange, for example, provides pre-trade transparency by collecting all orders in a public order book, which can be viewed by all users of the market. In addition, it provides post-trade transparency by providing information on done transactions. In such markets, transparency is a characteristic of the market that will be a material positive factor for many users when deciding whether to participate in the market.

At the low transparency end lie two traditional forms of financial intermediation. For capital raising, there is bank lending; for risk shifting, there is insurance. Compared with exchanges, the amount of information made public is minimal, and the regulatory regimes of low transparency institutions generally encourage an atmosphere of confidentiality.

There are also points on the continuum in between the two poles. Moving away from high transparency in capital raising are the over-the-counter securities markets. In capital raising, securitization, loan syndication, loan sales, and private placements occupy the middle ground between high and low transparency; in risk shifting, swaps and other OTC derivatives hold the middle. Such activities operate in a more open manner than traditional loans and insurance, but do not attempt to match the openness of the exchanges.

The primary factor differentiating the high transparency from the low transparency markets is information. The high end of the continuum is characterized primarily by public information, that is, by borrowers and lenders or by traders relying for the most part on information equally available to all. Firms raising capital on such markets tend to be those who can make their case for funding to the public. Further, liquidity tends to be focused on the organized exchanges, in

some cases by means of standardized contracts and terms, which make more of the traded instruments substitutable for each other. Finally, practices that increase transparency enhance the public nature of the information, that is, they attempt to minimise to the extent possible differences between information available to various transactors.

At the low transparency end, by contrast, the primary form of information is private information. Lesser-known borrowers, new ventures, and those with special financing and risk shifting needs are examples of transactors at the low transparency end. The lenders and dealers in such markets attempt to profit from investing in information about such borrowers, and the transactions tend to be conducted confidentially. Further, the nature of such markets makes them illiquid, and it is only by earning a return on investment in private information that the lenders will have the incentive to provide services in such markets. Attempting to mandate transparency in such markets would exacerbate their inherent illiquidity by taking away the incentive to operate there.

Swaps and other over-the-counter derivatives do not belong with insurance at the low transparency pole of the risk-shifting continuum, but they do lie more on the low than on the high transparency side. Because counterparty credit risk assessment and management are an integral part of the OTC derivatives markets, dealers expect to earn a return on the private counterparty information in the acquisition of which they invest. But in addition they form a bridge to more liquid and to more transparent markets in that the risks taken on in swaps transactions are often passed on to those markets on the higher transparency end of the spectrum. Indeed, OTC derivatives traders rely so heavily on the price discovery information provided by exchange-traded derivatives that OTC derivatives activity slows to a trickle during times when the futures markets are closed. Imposing futures-style transparency on OTC derivatives could upset the optimal balance of transparency in the market by reducing the return to credit intermediation by swap dealers and thereby increase the cost and reduce the availability of risk shifting products to those clients for whom higher transparency products (such as futures) are less feasible.

Special characteristics of the OTC derivatives market

In addition, any proposal to mandate transparency in the OTC derivatives market would need to address the issue that OTC derivative are a market for privately negotiated transactions between almost exclusively professional participants. While ISDA has developed standard templates, terms and definitions for market participants to use when creating their contracts, the parties to individual transactions can and do modify those terms and definitions or combine different elements or different contract types in a myriad of different ways to meet their individual needs. There is therefore a potentially unlimited number of different types of OTC derivative contract and the terms of individual, apparently similar transactions can vary in ways which are significant as to price. It is also a market that is highly dynamic so that contractual terms or structures evolve relatively quickly, with older and newer forms of apparently similar contracts often co-existing. In addition, the creditworthiness of the counterparty or the collateral or margin arrangements agreed between them will have an influence on the pricing of individual transactions, so that apparently similar transactions can have different prices because of differences in the counterparty's credit rating or because of differences in the collateralisation arrangements.

These issues can and do exist to some extent in the market for shares and bonds but to a much less significant degree. For example, differences in the contractually agreed settlement date (spot or forward transaction), other settlement terms or cum or ex dividend terms can mean that contemporaneous prices reported under the MiFID regime for a transaction in shares will differ for reasons which are not apparent to the user of the information. Even so, there are still only a finite number of shares admitted to trading for which the generality of prices will be comparable because they will reflect transactions on similar terms. The virtually infinite variety of different types of OTC derivatives transaction, in contrast, means that it would be a daunting task to create any reporting regime that could provide comparable and meaningful data at an acceptable cost and without requiring disclosure of individual transaction terms and, possibly, the identity of the parties to the transaction, which is in itself likely to lead to reductions of liquidity. This makes it even more important to determine the market failure that any transparency regime is supposed to address and to consider the costs of any such regime.

Market evolves its own response

There is strong evidence that, as they have evolved, different segments of the OTC derivatives market have developed ways to address market participants' desire for more information relevant to their transaction decisions. This has involved greater automation of the search or negotiation process, for example, through more efficient messaging systems or proprietary or multilateral dealing systems or bulletin boards; the provision by information vendors of price sources for key components of the contract such as LIBOR, Euribor or currency exchange rates; and the development of indices or benchmarks using panels of dealers to supply quotes on comparable terms to an intermediary that assembles an index based on those quotes. The credit derivatives market, for example, has rapidly evolved a number of indexes that now provide an important source of information and encourage liquidity,⁶ as well as pricing services to provide valuation information on credit default swaps.⁷

The professional nature of the marketplace means that there is significantly less need to mandate particular solutions as the parties should be the best judges of their own interests. Further, it is possible that mandated transparency, by increasing costs and specifying a particular solution, could short-circuit any evolution of market-based transparency provision that would otherwise arise in response to real market demands.

Interrelationship between cash and derivatives markets

It is sometimes argued that, as derivatives activity grows and markets mature, regulation of derivatives should be made consistent with regulation of the underlying cash market. ISDA believes that such arguments ignore the essential differences between cash instruments and derivatives. Full consideration of such issues is beyond the scope of this comment, so we focus here on the relationship between cash markets and derivatives as it relates to transparency.

Just as OTC derivatives rely heavily on price discovery information generated by exchange-traded derivatives markets, cash markets rely increasingly on information generated by OTC derivatives activity. In fixed income markets, for example, the maturity and high liquidity of interest rate swaps has led to swap rates' achieving par with, if not surpassing, government bond

⁶ See e.g. the iTraxx CDS indices (<http://www.itraxx.com/>).

⁷ See e.g. the services provided by Markit (<http://www.markit.com/>)

rates as benchmarks for medium- and long-term rates. Although most new fixed-rate issues are still priced at a spread over government bonds, it is common practice to rely on swap markets for secondary market trading (“price off treasuries, trade off swaps”). Interest rate swaps have enhanced transparency in fixed income markets by increasing the amount and quality of pricing information available to fixed income participants.

Credit derivatives provide a more dramatic example of increased transparency for underlying cash markets. Prior to the evolution of credit default swaps (CDS), credit pricing information in bond markets was limited and difficult to disentangle from liquidity pricing; asset swap spreads were the primary source of information. Credit pricing information for loans was even more limited, due largely to the private information considerations discussed above. As CDS have grown to cover more underlying credits and have achieved greater liquidity, there is now a benchmark against which to evaluate the pricing of credit risk. Somewhat paradoxically, the lack of formal transparency in the CDS markets has made possible a higher degree of transparency in underlying bond and loan markets.

ISDA believes that the inter-relationships described above demonstrate how important it is to avoid mandating levels of transparency that are inappropriate to the structure of a given market segment. The existing inter-relationships developed in response to many market demands, including demand for transparency, and it is likely to be counterproductive to attempt to second-guess the market by restructuring it to provide information that the market did not ask for. Of particular concern are suggestions that mandated transparency in credit derivatives markets is a substitute for mandated transparency in cash bond markets.⁸ We believe mandated transparency in the CDS market will have the unintended consequence of reducing CDS liquidity and thereby reducing cash bond market transparency. In any event, retail bond investors are unlikely to benefit to any significant extent from information about CDS rates (and would clearly be prejudiced if mandatory transparency led to a decline in liquidity).

Conclusion: Identification of the option that leads to greatest social welfare benefit

Based on the foregoing arguments, ISDA believes that the “no change” option of allowing market participants to determine the optimal level of OTC derivative market transparency leads to more efficient markets and therefore higher social welfare than would any form of mandated transparency. There has been no demonstration of market failure that calls for mandated transparency; it is therefore reasonable to conclude that the current level is optimal to the participants in the market. Further, we are convinced that mandated transparency will have the effect of increasing costs to market participants and reducing liquidity, which will reduce the economic benefits of OTC derivatives to market participants. Finally, we believe that, to the extent market participants demand a higher level of transparency, private alternatives will evolve that will satisfy the demand without a regulatory mandate.

Turning then to the specific questions set out in the call for evidence.

Q1: Do you have any comment on the proposed scope of the Report?

No.

⁸ M. Lagana, M. Perina, I. von Koppen-Mertes, and A. Persaud, “Implications for Liquidity from Innovation and Transparency in the European Corporate Bond Market.” ECB Occasional Paper, May 2006.

Q2. Do you consider this classification scheme to be sufficient for the purposes of the Review?

We note that the category of transactions grouped under the somewhat misleading title "credit derivatives" - which includes some transactions such as interest rate swaps and forward rate agreements that are not credit derivatives - creates the impression of a tightly defined, homogenous group of instruments. Yet even this group represents a virtually unlimited number of differing transactions, ranging from the "vanilla" three month fixed floating euribor interest rate swap to a vast range of different types of credit derivative, for example, single name, basket, index, first to default, Nth to default, physically settled, cash settled, with restructuring credit events and without, and so on across a rich variety of differing underlyings, currencies, maturities and transaction sizes. Another problem with the classification scheme is that it includes at least one exchange traded instrument - bond futures - yet excludes commodity derivatives and currency options that exhibit similar characteristics to interest rate swaps.

We question whether it is even realistic to imagine that there is any scheme that could effectively compel the publication of comparable, useful data across even this subset of the OTC derivatives market. Even if the mandatory transparency were limited to a very small subset of these instruments meeting some objectively defined category of terms, it would be of questionable value given the possibility for a market participant to negotiate different terms for its trades that it does not wish to report and the influence of counterparty credit related factors in pricing. In addition, the rapidly evolving nature of the markets would require constant monitoring in order to ensure that the chosen contract specifications remain up to date.

Also, there is a fundamental point that mandating transparency in the highly liquid "vanilla" transaction types may well achieve little, given the large amount of market pricing data available for those instruments, while mandating transparency at the other end of the liquidity spectrum is likely to drive liquidity away from markets.

Q3. Do you consider that there are possible policy rationales for mandatory transparency we have not listed?

If the Commission intends to approach the subject of transparency with an open mind, we believe credibility would be enhanced by the presentation of policy rationales for the "no change" option of no mandated transparency.

We believe further that it is vital that the Commission recognise that the burden of proof to demonstrate market failure and the proportionality of any response should be on those seeking to argue for an extension of transparency requirements. The fact that the OTC derivatives market is highly competitive and efficient and has evolved pricing and other information sources to meet its needs over the years, suggests that there is no market failure. On the other hand, a consideration of the infinite range of possible OTC instruments and transactions suggests that almost any mandatory form of transparency will either be ineffective or disproportionately burdensome and counterproductive, because of the impact on liquidity.

Not all the cited factors are relevant arguments for introducing transparency requirements. In particular, the factors cited under "response to technological developments" suggest the contrary conclusion.

Q4. Do you agree with our proposals for prioritisation of the review?

We consider that the Commission should not include OTC derivatives in the review at all. For the reasons discussed in the foregoing analysis, we believe there are compelling reasons not to impose transparency requirements on OTC derivatives. However, the Commission should clearly take into account the pricing role that OTC derivatives have in relation to the cash market when considering whether there is a case for extending transparency to the cash markets; the Commission might well conclude that the transparency provided by derivatives makes mandated cash market efficiency unnecessary.⁹

We assume that the Commission is including credit default swaps as a relatively low priority item because of their possible role in cash bond price discovery, although we believe that the relationship of credit default swaps to retail investors is remote at best. But we do not understand the rationale for including interest rate swaps as potential candidates for mandated transparency.

However, we strongly agree that that it would serve no useful purpose at all to explore transparency issues in relation to your final category of "other financial instruments". For example, we consider that there is no useful purpose in exploring the development of mandatory transparency regimes for commodity derivatives.

Q5. To what extent do you consider there to be:

- a. observable or demonstrable problems with respect to the possible policy rationales for transparency identified above in relation to one or more of the instrument markets under review?**
- b. evidence that mandatory pre- or post-trade transparency would solve any of those problems?**

We do not consider that there are observable or demonstrable problems of a kind that would justify the imposition of mandatory pre- or post-trade transparency. It appears that the main argument for mandated transparency is that there is currently no mandated transparency.

Q6. To what extent could recent and upcoming technological and market developments in relation to the instrument markets under review:

- a. contribute to a relatively inexpensive extension of mandatory transparency?**
- b. render mandatory transparency unnecessary?**

Regarding the OTC derivatives market, we consider that the rapid evolution of the market and the development of new benchmarks and indices as market segments become more liquid - credit derivatives are a case in point - illustrate that that it is not necessary to seek to impose regulatory transparency requirements. ISDA appreciates the Commission's recognition here that market evolution could make mandated transparency unnecessary; we hope the Commission will also recognise that market-developed transparency might take a very different form from the types that have been mandated by regulators.

⁹ Lagana et al. (2006).

7. To what extent are non-equity financial instruments different from equities so that lower levels of mandatory transparency in those markets may be justified?

See the above discussion.

Q8. What data sources do you consider relevant to the issues you have raised (if appropriate, cross-refer to your answers below)? Would you or your organisation be prepared to produce any relevant data if necessary?

ISDA would be happy to discuss any requests for relevant data that the Commission may make.

Q9. Are there academic or institutional papers or ongoing work that should be considered in preparing the Report not included in our bibliography?

See the Joint Response. Notable omissions include Maureen O'Hara, Market Microstructure Theory (1995); and Larry Harris, Trading and Markets (2003).

Q10. What conclusions do you draw from the existing academic debate and the ongoing work being conducted by the interested parties?

See the above discussion and the Joint Response. As a general matter we suggest that, while academic studies can provide useful insights in understanding markets and formulating policy, more effort should be devoted to understanding why real world institutions and practices evolved in the way they did and how existing institutions and practices might be optimal adaptations to constraints faced by market participants. We do not believe that the results of models, which are abstract simplifications of the real world, can be applied in a literal manner to actual institutions. We believe that it is inappropriate to use divergences between theoretical models and existing institutions as evidence of market failure.

Q11. In your view, how applicable is the academic or institutional literature concerning transparency in the cash equities markets to the present discussion?

As we discuss above, the academic literature generally uses quality of price discovery as a criterion for judging the benefits of transparency. Because prices in OTC derivatives transactions do not normally serve a significant pricing function, the academic literature is of limited relevance to the policy question of mandated transparency in OTC derivatives activity. The one area where OTC derivatives might arguably serve a significant price discovery function is credit default swaps for bonds; unfortunately, it appears that analyses of this area have focussed on the effect of transparency on the liquidity of the underlying bond markets but not on the liquidity of credit default swaps themselves.¹⁰

Q12. What similarities and what differences are there between US and EU markets that should be borne in mind when seeking to draw inferences from the TRACE experience in the US?

This question does not concern the OTC derivatives market.

Q13. To the extent that you have identified problems or believe that others may do so, do you agree that only EU-level action would be appropriate in the present case?

¹⁰ See, for example, Lagana et al. (2006).

We favour the no-change option in relation to OTC derivatives and believe that it is important to achieve an EU wide consensus on this to discourage any member states from adopting unilaterally super-equivalent requirements for OTC transactions, even though the likely effect of any such requirement would be to drive OTC derivatives business elsewhere.

Q14. If you have identified problems or believe that others might do so, to what extent do you consider those problems would disappear as a natural product of market evolution in the short-to-medium term?

We consider that the OTC derivatives markets have shown themselves to be competitive, flexible and responsive.

Q15. In respect of both pre- and post-trade transparency, are the four options the right ones to consider, and in particular should other options be considered?

As we argue above, we favour the no-change option in relation to OTC derivatives and believe that the other option should be limited to the mandated transparency in general regardless of the form it takes.

Q16. Would you, in light of your answers to the other questions, favour any of the four options in relation to pre- and post-trade transparency (or another option you might propose for consideration) in respect of transactions in any of: [list of financial instruments].

As argued above, we favour the no-change option in relation to OTC derivatives.